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A TAX PROGRAM FOR PUERTO RICO

LOUIS SHERE *

THE imbalance between material and human resources constitutes the most important problem which currently confronts the interdependent nations. Those more favorably situated may well expect to contribute, perhaps for generations, to the rectification of political and economic maladjustments that stem from this origin. Nature has been niggardly in Puerto Rico, as in many parts of the world, except for human resources. Material resources appear to be inadequate to provide the densely populated island with minimum economic needs.

Our interest in the welfare of Puerto Rico is broadly based, for the problem of stimulating its economic growth is very like the general problem of promoting economic progress in all underdeveloped countries. But in Puerto Rico, as elsewhere, it must be acknowledged frankly that the problem is only partly economic. Without some form of population control, it is questionable whether the economic status of the great majority can be elevated to the level of a tolerable minimum. If human resources are not to run to waste through underutilization in peace or worse in war, the peoples of the world must face realistically the population problem. There are limits to what may be properly expected from the improvement of national and international economic organization. The vexing population issue cannot be ignored. This article on tax reform in Puerto Rico deals only with a fraction of that fraction of the problem which is economic.

Background

At the top levels of the Puerto Rican government one encounters a degree of economic sophistication which at least matches that of the federal and state governments on the mainland. Below the top levels there is a great void of technical competence. As a result of this gap, the burdens on officers of cabinet and similar rank are enormously increased. For some reason the educational system fails to supply the government (and business too) with the urgently needed personnel in economic and allied fields. Some effort is being made to narrow this gap through a system of government supported scholarships for study abroad, but the program

* The author is professor of economics and director of tax research at Indiana University. This article is based on a report prepared as consultant to the Treasurer of Puerto Rico during the period June-September, 1951.

will need to be pursued on a much more ambitious scale if government and business are to be supplied with personnel adequate to keep the services efficient.

More things are planned than manned. Perhaps this is as it should be. Yet government must always guard against the danger that lurks in the processes of repetitive consultation and discussion at the executive level, lest these be permitted to develop into undesirable political techniques that substitute for decision and practical action.

Puerto Rico is in hot pursuit of economic development. Special governmental and financial organizations are designed to accomplish this objective, but this is no experiment in socialism. To serve the public purpose, government does not shrink from initiating risk-loaded projects that private enterprise feels compelled to shun. Later the successfully launched projects, as well as the failures, are sold to enterprising private investors. Moreover, over a wide economic front the government seeks to stimulate private enterprise to assume the risks of exploratory investments. For this purpose the government's major weapon has been tax exemption. The government is committed to this policy for a specific period terminating fully in 1962. The pressures for revenue from the twin demands for economic development and the expansion of governmental services may well be expected to grow. This raises a practical question of the role of tax reform as a substitute for tax exemption.

Puerto Rico's economic problems stem from a combination of a high population density and general economic underdevelopment. The estimated population density is among the highest in the world, 645 inhabitants per square mile. Unemployment and underemployment are chronic despite a net annual emigration which has averaged over 30,000 persons in the post-World War II period. About 40 per cent of the labor force is either underemployed or unemployed, and the underemployed are roughly twice the unemployed. About 60 per cent of the population is rural. Income levels are low. Only about 40 per cent of all Puerto Ricans 14 years and older have annual money incomes in excess of $500. Less than one-fifth of all employed earn more than 50 cents per hour, and more than a third earn less than 30 cents an hour. Prices in general have moved sympathetically with those on the mainland so the purchasing power of the low incomes has been further depleted by the war and postwar inflation. Profits as a distributive share of insular income during the postwar period are about as high a percentage as on the mainland, and they are concentrated largely in the fields of agriculture and trade. The external account of Puerto Rico runs a consistent deficit which is financed by capital imports and large federal expenditures in the island. This supplementation of insular resources has helped to mitigate inflationary pressures.

Government Finances

Puerto Rico has recently acquired the status of a commonwealth under the American Constitution. Even as a possession it had a large measure of fiscal independence. It had an independent income tax system which in general did not overlap that of the federal government, as is the case of the other income taxes levied below the level of the fed-

eral government. Like the states, it is the beneficiary of a system of federal grants. It also gets back from the federal government the excises collected with respect to all imports from the island to the mainland and the customs duties collected on all imports into the island from foreign countries. None of the benefits enjoyed by Puerto Rico as a possession have been abrogated under its new commonwealth status. Indeed, its fiscal independence has been augmented by transferring the appointment of the auditor from the President of the United States to the governor of Puerto Rico.

The system of government accounts in Puerto Rico is antiquated. For many purposes it is well nigh impossible to derive significant fiscal data from the available classifications. A multiplicity of special accounts and inconsistent procedures for their integration with the general account serves to improve the chances for duplication and omissions, not merely from the subclassifications but also from the aggregates. For example, during the course of my investigation, those in the best position to interpret the figures failed in two independent efforts to reconcile the cash balances, the revenues, the expenditures, and the public debt of Puerto Rico for even a single fiscal year. The auditor's office, the Bureau of the Budget, and the other agencies of government concerned with fiscal planning operate on different planes of analyses in an essentially uncoordinated way. None of the agencies yield up the fiscal data that are essential for an effective evaluation of the various governmental programs and services taken either separately or in combination. The governor and his minister of finance have been overly patient in playing the game of hide-and-seek with fiscal figures. But they recognized this deficiency and both were receptive to suggestions that a governmental committee be established, with appropriate consulting experts, for the purpose of devising ways and means of reorganizing the accounts along the lines of those established by the Bureau of the Census of the Department of Commerce for state and local governmental units of the United States. It is altogether likely that this project will be speeded to a successful conclusion by the recent realignment of the responsibilities of the fiscal agencies incidental to the adoption of the new constitution.

As the result of tedious special studies and analyses of the government accounts, it is now practicable to present some of the important facts relating to the government finances of Puerto Rico, but this can be done only in very broad terms.

The combined insular and municipal debt as of June 30, 1950, amounts to \$45.7 million, about 7 per cent of the insular income of \$648.4 million which is estimated for the fiscal year 1950. This combined debt had decreased \$18.1 million in the five-year period of arrested capital expenditures and lush " rum tax " yields terminating June 30, 1945. It increased \$17.6 million during the subsequent five years when the government strove to catch up on the deferred expenditure programs, and the returns to the insular government from the rum tax (the federally collected excise tax on rum imported from Puerto Rico to the mainland) shrank. The

federally collected excises (principally from rum) and customs duties returned to Puerto Rico fell from 41.8 per cent of total revenues of the insular government for its own purposes in the first five-year period to 17.9 per cent in the second.

In addition to the direct debt, government enterprises and public corporations had an outstanding indebtedness of $94.2 million against total assets of $305.0 million as of June 30, 1950. Five years earlier both the debt and the assets were about one-third as large. The contributions of the insular government up to June 30, 1950 amounted to about one-third of the assets of the public enterprises.

Both the direct debt of the insular and municipal governments and the debt of public enterprises are held principally in the United States. A substantial fraction, particularly of the direct debt, is held by the banks and insurance companies, including branches of some of the leading financial institutions in the United States and Canada, operating in Puerto Rico.

Over-all, the financial condition of Puerto Rico seems sound. The public enterprises have book assets amounting to three times their indebtedness. The direct government debt is a small percentage of insular income. The fact that the debt, both direct and enterprise, is for the most part held externally is not overly significant because in relation to income the debt is not large, and there is no foreign exchange problem of the type that confronts many independent countries. The fruits of the increase in production made possible by capital imports, however, must be shared with the external capitalists as they would not need to be if it were possible for the island to become a self-sufficient source of capital. Such is the dilemma of all underdeveloped countries. They seek outside capital to irrigate their potential productive resources; yet in the face of their more urgent economic needs they find it politically difficult to agree upon an appropriate "sharing" of the product.

The indirect effects on unemployment and production customarily do not receive adequate weighting in these complex "sharing" formulae, but in Puerto Rico, a commonwealth under the American Constitution, it is different. The indirect benefits are stressed. There is no fear of exploitation. Here the record of American financial generosity stretches back over half a century. The emphasis is upon enticing private American capital, and the problem is that of choosing the best and most enduring means to this end. Tentatively the choice has been tax exemption. This is an excessively generous sharing formula on the part of the island. It is politically brittle, and it cannot be welded to a stable economic policy. Even if the indirect benefits of capital import dominated, it would require a people with an unlimited lack of imagination to forego some part of the product directly attributable to the imported capital.

Present Tax System and Recommended Reforms

Over-all, taxes in Puerto Rico are light. In the fiscal year 1950 the combined insular and municipal taxes amounted to less than 13 per cent of insular income, approximately one-half of the corresponding percentage for the

United States. Since 1950, as a result of the defense effort, the tax burden for the United States has increased substantially, but there has been no corresponding increase in Puerto Rico.

The taxes in Puerto Rico, however, are not distributed in a manner that makes even the relatively light load easy for the people and the economy to bear. There is undue emphasis on a system of excises and licenses so complex that it burdens the tax administrators and the complying taxpayers out of all proportion to the revenue yield. Also, undue emphasis is placed on shiftable components of the property tax, which in their economic effects are similar to those of sales and excise taxes, and underemphasis on those components which are not. The income tax, in general, is underemphasized. It is structurally defective and prejudicial to the importation of capital.

My recommendations to the government of Puerto Rico related primarily to reforms needed to attain a more equitable distribution of the tax burden and to harmonize the tax system with the requirements of the government's broad economic development program. It was felt that some experimentation with effective administration of the recommended tax system should precede any further adjustment of tax rates to improve the adequacy of the tax system.

Two important recommendations were made outside this area: the first involved the establishment of reserves out of the revenues of the federally collected excises and customs and the articulation of these revenues with expenditures for economic development; and the second related to problems of tax administration.

Under the first of these recommendations, the revenues from federally collected excises and customs would be reserved primarily, but not necessarily exclusively, for economic development. In years of high yields from these sources, reserves would be accumulated to be drawn down in periods of recession for either developmental or general governmental purposes. The government would resort to borrowing only after the reserves had been exhausted. It seems reasonable to tie the extraordinary amounts of federal aid represented by the return of these revenues to the program of economic development and gradually to strengthen the balance of the revenue system so that, together with grants of the type ordinarily made available by the federal government, it could carry the expanding regular governmental services. The suggested plan is designed to chart the fiscal policy of Puerto Rico toward appropriate rates of expenditure both for economic development and for the expansion of the regular governmental services. Without it, the expanded legal borrowing capacity incident to the recent reassessment of property is more likely to be dissipated outside the area of economic development. The Planning Board optimistically forecasts that for the period 1953-1957 the average annual revenue from federally collected excises and customs will exceed development expenditures by about $4.5 million. In the period 1946-1952 the average annual development expenditures exceeded such revenues by $5.4 million.

The reserve suggested is a partial application of a plan that I first developed some twenty years ago for the implementation of budgetary policies of juris-

dictions below the federal level. I have espoused this controversial fiscal gadget ever since 1932, but it has made little headway against a double-barreled attack. On the one hand, it is maintained that under perfect budgeting procedures and perfect political communication between the electors and the elected, the gadget would be superfluous —indeed, worse, it would almost certainly thwart the public will and jam the social utility calculator. On the other hand, it is contended that under imperfect arrangements, leaving pork barrels aside, the building of tax reserves against enormous pressures to expand public expenditures during periods of prosperity is a political impossibility.

My belief, however, is that somewhere in between the perfect and the imperfect there is room for my timid suggestions to Puerto Rico: quite apart from the aid which it might provide the government of Puerto Rico in planning its budget, it would provide the Congress of the United States with a convincing rationale for the extraordinary financial arrangements whereby there is returned to the island the excises and customs duties originating from its exports to the United States and its imports from foreign countries.

Under the second ancillary recommendation relating to administration, I urged the institution of a system of individual accounts for the taxpayers with substantial means. Such a system would facilitate the disclosure of tax evasion by permitting the data submitted with respect to the various levies to be cross-checked. This system is long overdue in the United States, and perhaps more so in other developed countries, but the relatively large numbers of taxpayers with substantial means and the problems of intergovernmental jurisdiction can be expected to continue to retard this much-needed and inevitable reform. In the underdeveloped countries neither of these obstacles militate against the early adoption of the proposal. In Puerto Rico the tax arrears, particularly with respect to income and property taxes, bear mute—too mute—testimony for the urgency of this entirely feasible reform.

The best tax system will bog down in a slough of corruption and undercompliance if tax administration is weak or arbitarary, but the poorer the quality of the tax system, the less spontaneous and cooperative are taxpayers likely to be in complying with taxes, and the less likely is the administration to be effective. To begin with, therefore, it is essential to operate at the level of tax reform, for without the adjustments required to make the tax system comport with accepted standards of equity in the light of local economic requirements, reforms of tax compliance and tax administration procedures are doomed to failure. Moreover, the concepts of equity compromised by local economic requirements are themselves not standardized, interchangeable parts of a model tax system, good any time and anywhere in the world. For this reason it is perhaps fortunate that the advice of outside experts is filtered through a succession of experts and ultimately again through the successive layers of the executive and legislative branches of the consulting government.

As of September, 1951, the latest fiscal data for the insular and municipal governments combined were for the

fiscal year 1950 (Table 1). These data show that of total revenues, federal grants and the return of federally collected excises and customs accounted for 16.0 per cent. Of the balance of seems to rank high compared with that of the state and local governments of the United States, and it is respectable even if compared with the revenue systems of most independent countries.

TABLE 1

Existing Revenue System * and Recommended Changes

(In thousands of dollars)

Source	Fiscal Year 1950: Total insular government and municipalities	Fiscal Year 1950: Insular government	Fiscal Year 1952 (Estimated): Insular government	Changes under Recommended Program
Excise taxes	$ 41,392	$ 40,251	$ 45,873	$ - 6,800
Business licenses, permits, fees, etc.	6,802	5,504	5,500	+ 1,400 †
Income tax	27,960	27,960	26,825	+ 5,400
Property tax	14,548	5,377	6,050	‡
Inheritance and gift taxes	715	715	900	§
Lottery proceeds	4,758	3,702	4,000	....
Miscellaneous revenue	8,621	6,897	6,398	....
Subtotal	$104,796	$ 90,406	$ 95,546	
Customs duties on imports from foreign countries	$ 2,392	$ 2,392	$ 2,000	
United States excise taxes on imports from Puerto Rico	9,575	9,575	15,000	
Federal grants in aid	8,053	8,053	15,571	
Total	$124,816	$110,426	$128,117	

* The fiscal year 1950 data exclude entirely the effect of Acts 219, 220, and 438 of 1951 which were estimated to increase revenues from tobacco products, $2,000,000; from income tax, $1,398,000; and from alcoholic beverages, $4,000,000. The estimated 1952 data include about one-half of the amounts estimated for tobacco products and alcoholic beverages but none for income tax.

† Many licenses are eliminated or decreased, but the decreases are more than offset by a very substantial increase for licenses of motor vehicles, particularly passenger cars.

‡ The revenue lost from the recommendation to repeal the tax on business personal property is replaced by an additional graduated tax on other property; over-all, therefore, no revenue change from property taxes is involved.

§ A small increase, not estimated.

revenues, excises and licenses were 46.0 per cent; the income tax, 26.7 per cent; the property tax, 13.9 per cent; the inheritance tax, 0.7 per cent; the lottery, 4.5 per cent; and other miscellaneous revenues, 8.2 per cent. Viewed globally, the Puerto Rican tax system From this fact, however, it cannot be concluded that the defects which appear upon close inspection are trivial; on the contrary, as the rest of this article attempts to show, the Puerto Rican tax system is in urgent need of a complete overhaul.

Excise Taxes and Licenses

Excise taxes and licenses constitute the most important component of the Puerto Rican revenue system, accounting for over 40 per cent of combined insular and municipal revenues. In practice, excises are levied only by the insular government, whereas licenses are levied by both the insular government and the municipalities. There are duplications, however, between insular excises and insular licenses, and there is substantial overlapping of insular and municipal licenses. Many of the levies qualify as "nuisance taxes." To the taxpayers, the adminstration is more meddlesome than efficient. They are unaware of the rationale and policy that binds the congeries of excises and licenses together. This serves to undermine the tax morale and to multiply the problems of tax administration. Moreover, any defection in tax compliance, even if founded upon a wholesome conception of tax equity, tends to spill over to areas of taxation that are more solidly founded in principle, and ultimately it will rot the entire financial foundations of government. Thus revision of the system of excises and licenses, as indeed of any other defective component of the tax system, is urgently needed in the interest of preserving the integrity of the whole revenue system.

In deed as well as in purpose, the government of Puerto Rico has been moving in the general direction of eradicating the worst features from its tax system. In this connection, the part played by the unpublished but well-mined report prepared by Professor Robert Murray Haig in 1946 has been substantial. In the area of excises and licenses, as well as elsewhere, much has already been accomplished and much still remains to be done. Many business cost excises have been eliminated or de-emphasized in harmony with the general program for economic development. The proportion of the revenue from excises and licenses earmarked for specific purposes and the number of special trust accounts have been greatly reduced. Less than 2½ per cent of the revenue from insular imposed excises and licenses is now earmarked for special insular purposes.

Earmarking is prejudicial to sound budgetary practices. Only by remote chance can the level of receipts from a specific tax source happen to match the revenue required to finance a given function of government in accordance with the public's incompletely articulated scale of preferences. Responsible government in a democracy cannot escape the difficult task of assigning revenues to functions on this basis. Earmarking short-circuits but does not solve this fundamental problem. In the short run it may be politically comfortable, but in the long run it can succeed, if at all, only when the revenue is assigned to a function of top rank with an insatiable appetite for public funds, as in the case of education and charities. On the whole, it seems preferable to eradicate the practice completely.

Insular excises. The excises apply to articles imported or manufactured for use as well as to sales. The principal excises collected by the insular government are alcoholic beverages, gasoline, vehicles and accessories, electrical apparatus, sugar and molasses, and amusements.

Some excises are specific, such as gasoline, but most are ad valorem based on "selling price in Puerto Rico," which is defined as cost in Puerto Rico plus a 20 per cent margin. In the case of imported articles, cost in Puerto Rico is cost at origin plus 10 per cent for freight, insurance, and transportation expenses. Over 90 per cent of all imports are from the United States and hence are duty-free. The balance of the imports are subject to United States tariff duties. The duty is excluded from the base for excise tax.

The administration of the excises could be greatly strengthened if the government were to require either prepayment of tax or bonding before imports were released. Prepayment of tax is now required only in the case of cigarettes, and bonding is required only for petroleum products and vehicles.

Under the recommendations some excises will be completely eliminated, some de-emphasized, and others increased. The revenue effects of the proposed changes are summarized in Table 2.

TABLE 2

Summary of Revenue Effects of Excise Tax Recommendations

(In thousands of dollars)

Excise taxes recommended for repeal	$ -5,575
Excise taxes recommended for de-emphasis	-3,258
Excise taxes recommended for increase	+2,041
Total revenue effect from excise tax recommendations	-6,792

The excises recommended for repeal include chewing gum, candy, kerosene, business documents, trucks and buses, lubricating oils, auto parts and accessories, tires and tubes, matches, and a substantial list of lesser taxes. These excises are highly regressive, they add to business costs, overlap other levies, yield negligible revenue in relation to compliance and other administrative costs, lack logical foundation, are unduly vexatious, or suffer from a combination of defects.

The principal excises recommended for de-emphasis, primarily to lighten the regressive tax burden, include cigarettes, electrical or gas apparatus, electrical fans and ventilators, and amusements. Of these the cigarette tax, which in 1951 was raised by 4 cents to 19 cents a package, is by far the most important and the most offensive. The bulk of the cigarettes, which retail at about 30 cents a package, are consumed by individuals with very low incomes. Puerto Rico should be much closer to exhausting its taxable capacity before such high taxes on widely consumed inelastic items can be justified. Under my recommendations the tax would be 100 per cent of the wholesale market price, exclusive of internal revenue tax, and thus it would revert to roughly the pre-July, 1951 level of 15 cents. Even this proposal may leave the rate too high. In support of what some will doubtless regard as a mild change, it is well to remember that the reform of a tax system is more likely to be accomplished in the relative calm of gradual burden shifts than in the turbulence of sharply clashing interests.

The excises recommended for increase include the taxes from gambling and the higher priced alcoholic beverages, cigars, and passenger cars. Of these the most important increase resulted from the stepped-up taxes on higher priced automobiles. Under the recommendations the rate for passenger cars selling

for over $2,000 in Puerto Rico would be increased from 20 per cent to 50 per cent. The rate for lower priced cars would remain 20 per cent.

Insular licenses. The system of Puerto Rican licenses is even more complex than that of the excises. They are differentiated by type of activity in a manner that defies rationalization. The rates are roughly proportional to the volume of business. The insular licenses almost completely overlap those imposed by the municipalities.

Under the recommendations most licenses are replaced by a flat registration fee of $10 per annum. The chief exceptions involve regulatory situations including liquor, firearms, and licenses for motor vehicles. The substitution of the $10 registration fee for existing licenses other than motor vehicles would result in a revenue loss; but, after the sharp increase recommended for motor vehicle licenses, this loss would be more than recouped. The steep increase in the motor vehicle licenses is justified by the failure to adjust these licenses sufficiently when motor vehicles were completely freed from the property tax. As a consequence, the licenses are now lower than the property tax would be at current rates and tax valuations. If, as is stated, the recent policy to exempt motor vehicles from property tax was based on administrative considerations, then it is not defensible to carry into the licenses a substitute property tax component which is substantially below the property tax equivalent. To do so implies negative license taxes.

The rates recommended for passenger-carrying vehicles are $10 per passenger and for heavy motor vehicles, $40 per ton. The horse power factor which affects the rate of wear and tear of highways is thus not directly taken into account under the license system for reasons of simplification, but perhaps this is reasonable since this factor is automatically taken into account under the complementary excise tax on gasoline. The rates for trucks are relatively favorable. This seems warranted by their important role in the transportation system of the island.

The revenue effects of the proposed changes in insular excises are summarized in Table 3.

TABLE 3

Summary of Revenue Effects of Insular License Tax Recommendations

(In hundreds of dollars)

Licenses repealed or reduced	$ − 953
$10 registration fee substituted	+ 479
Licenses increased	+ 1,872
Total revenue effect from insular license changes	+ 1,398

The combined revenue loss from changes in insular excises (Table 2) and licenses (Table 3) becomes $5.4 million, the loss from excises of $6.8 million being offset by a gain on licenses of $1.4 million.

Municipal licenses. The patentes, or business licenses, constitute the most important source of municipal revenue from independently imposed levies. The rates vary by industrial classification and by volume of business. Those with annual receipts of $500 or less are exempt. Over 60 per cent of the patentes are collected in the capital city of San Juan. The five largest municipalities account for all but 2 to 3 per cent of the revenue.

Under the recommendations the patentes would be replaced by municipal supplements to the insular income tax. The supplements would be independently imposed by municipal ordinance at rates that would vary among the municipalities but would be administered centrally by the insular government. The base for supplements would be business and other property income of individuals, which, under the proposals described below, includes the income allocated from partnerships and corporations. Such supplements would remedy the important defects experienced with the patentes; they would simplify and increase the efficiency of tax compliance and administration. The patentes score low on both counts. They would help restore to the municipalities a measure of much needed fiscal independence. Political democracy is handicapped without the training ground of a virile system of local government. Also, the supplements would have the effect of mildly differentiating the income tax since over-all higher taxes would be imposed on business and property income rather than on earned income. Within the limits of the suggested maximum rate, set initially at 0.8 per cent, this could not prejudice investment incentives seriously. When fully exploited, such a limit on the rate would result in about one-third more revenue than the patentes now yield. To provide the municipalities with still more revenue independently imposed, it would be necessary to adjust the supplement limit upward. A low limit seems desirable for a period of experimentation, because unforeseen problems may emerge under the application of supplements to the income tax.

The Income Tax

The revenue from the income tax is roughly 60 per cent of the revenue from combined insular and municipal excises and licenses. It accounts for about 22 per cent of total governmental revenues. About 5 per cent of the income tax yield is derived from withholding on nonresidents, and the balance is split roughly 50 per cent from individuals and 50 per cent from partnerships and corporations—the partnerships being treated as independent tax entities in the same way as our corporations.

Under the recommendations the revenue potential of the income tax would be increased to offset the loss of $5.4 million of revenue from the changes in the excises and licenses, the components of the income tax would be integrated to eliminate double taxation, and various other structural changes would be made to improve incentives for economic development.

Integration. The marginal individual income tax rates are graduated from zero for incomes below exemptions of $800-$2,000-$400, 12.60 per cent for the first $2,000 of income above exemption, to 82.95 per cent for the bracket of income above $200,000. The marginal rates for partnerships and corporations are graduated from 21 per cent for incomes below $25,000 to 36.75 per cent on incomes over $133,333. The combined marginal rates on distributed business profits can only be illustrated for assumed situations, since the rates depend on several variables. Perhaps the most instructive illustration results from assuming the applicability of the top business entity rate of 36.75 per cent in combination with different levels

of individual income. This highlights the two major defects of the existing unintegrated income tax—inequitable distribution and deterrent to investors. At the level of surtax income $2,000, the addition to the marginal rate by reason of the existence of the tax on the entity is 30.6 points whereas at $200,000 it is only 5.96 points. The percentage increase attributable to the entity tax scales down from 242.8 to 7.2 for the selected incomes. The " double txation," defined as increase in the total income tax on account of the entity tax, burdens the low income recipient of business profits relatively more than the high income recipient.

Even if equity considerations are left aside, Puerto Rico, bent on pursuing an all-out tax incentive program, cannot consistently retain an income tax system with combined marginal rates which over the selected income levels range from 43.2 per cent to 88.9 per cent of distributed profits. Hence, under the recommendations, the business entity taxes are eliminated, and the entity profits of both corporations and partnerships are accounted under the individual income tax according to United States income tax procedures applicable to partnerships. However, to avoid a leakage of tax internally and its undue postponement with respect to profits paid to interests out of the island, a withholding tax of 25 per cent is recommended. This tax source would be credited against the individual income tax and against the current withholding tax of 29 per cent on nonresidents.

The existing withholding on nonresidents is conceptionally in lieu of individual income taxes of residents. The difficulty, however, is that the top rate entity tax and withholding on the residual that is distributed adds up to a combined tax of 56.54 per cent which is too high, considering the risks and costs of following investment abroad. Under the recommendations the ultimate tax of profits distributed abroad would amount to only 29 per cent since the 25 per cent withholding tax initially imposed would be credited against the 29 per cent withholding tax at the time of distribution. Double taxation would thus be eliminated with respect to distributions made both at home and abroad.

Net business losses. Integration of the individual and business entity income taxes would stimulate investment incentives, essential for the economic development of Puerto Rico, but liberalization of the income tax treatment of net business losses would seem to hold even greater promise. It is surprising to find that under the Puerto Rican income tax such losses may be carried forward to only one year and back to none. The explanation appears to be that hitherto the government has looked to the " tax holiday," a widespread system of exemptions from income, property, and all municipal taxes and licenses to provide whatever incentives are needed to attract commerce and industry to the island. There are no indications that this policy will change, but a strong case can be made for its displacement by liberalized treatment of net losses.

Ever since 1919 Puerto Rico has experimented with tax exemptions, but the policy did not come to full bloom until 1947. New industry is granted

total exemption until June 30, 1959, then partial exemption for three additional years at rates of 75 per cent, 50 per cent, and 25 per cent. After June 30, 1962, the enterprises are restored to the status of full taxability. A substantial expansion of facilities of production of an old business would qualify it for exemption if it produced one of some 42 categories of enumerated articles, the production of which the government seeks to promote. Also, exemption spreads with the entry of each new qualifying firm for old competing firms are simultaneously put on an equivalent tax exemption status. Hotels that qualify as promoters of tourist trade have also been granted tax exemption. Here it seems as if only the timid or inexpert in the mysterious mechanics of a bootstrap economy fear an excessive erosion of the tax base and the inevitable clash of economic and political interests of the taxed and the untaxed. Tax incentives have their limitations. The economic pie cannot be made to grow to any desirable size merely by reducing tax rates, even to zero as under a system of exemptions. But the issue which confronts Puerto Rico, or indeed any underdeveloped or developing economy, is not whether tax incentives should be exploited to the full. Obviously they should be to the extent that they are efficient. It is rather a problem of selecting the most efficient form of incentive. Since the evidence is not clearly on the side of one competing device, it is necessary to rely upon two distinguishing characteristics of man—judgment and reason—which are not distinguished for stability. On the basis of these unreliable guides, it would seem that the advantage lies on the side of a liberalized treatment of business losses.

Specifically, it is recommended that the government assume liability for one-half of business losses in the areas of commerce and industry it has marked for subsidy through tax exemption. This would eliminate subsidies for profitable businesses; to do so seems necessary if those who are compelled to pay higher taxes are not to become restive. The sharing of losses seems a more reasonable basis for stimulating investment, and the sharing to the extent of only 50 per cent would stop fly-by-night ventures at the expense of the Puerto Rican government. Such a liberalized loss treatment would replace tax exemption for income, property, and other taxes when the existing tax exemption is scheduled to be terminated in 1962. In the meanwhile taxpayers would be given a choice between the new and old incentive plan. In this way it could not be charged that the government had welched on its commitment.

Averaging of individual incomes. Averaging individual incomes for tax purposes is a third way to provide tax incentives. Business incomes are highly unstable. Averaging would mitigate the severity of the progressive rates for such incomes. Moreover, since the special, liberalized, net loss treatment would not apply outside the government's designated area, averaging would liberalize the loss treatment outside the designated area by permitting such losses to offset incomes realized during the averaging period. For practical administrative reasons and because the emphasis is on incentives rather than equity, the recommendation is that averaging be confined to all individuals

with gross incomes from business and professions, irrespective of amount, and all other individuals with net incomes of $3,000 or more. At the termination of each five-year period the government would recompute the taxes on the basis of average income for the period and at the rates and marital facts prevailing in each of the five years; the difference between the sum of such taxes for the period and actual taxes paid would be refunded, except that for administrative considerations no refunds would be made with respect to the first $20 of such difference.

It should be noted that the special net loss provision would be integrated administratively with averaging. Under averaging, refunds would be made to taxpayers with fluctuating incomes even if their average income was positive. Refunds on account of net business losses would also be made at the conclusion of the five-year averaging period. Where the losses had not been fully absorbed by the profits and other income realized within the period, so that the computed average income is negative, the refund would be the entire amount of tax collected during the period plus an amount represented by the difference between this and 50 per cent of the net losses.

Other income tax issues. Other revisions of the income tax are under discussion, influenced strongly for better or for worse by the pattern of the United States income tax.

For example, under existing Puerto Rican law, capital gains are generally taxed as other income, and capital losses are allowed to offset other income fully except in the case of securities where capital losses are limited to capital gains. An exception is made in the case of real estate (other than business property subject to depreciation) held by an individual for more than one year. Only 25 per cent of capital gains realized on such property is taken into account and capital losses are disallowed. In no case is provision made for a carry-over of capital losses. There is substantial pressure to generalize the special capital gains provision or otherwise to bring the treatment of capital gains and losses more in accord with the United States law. The existing law provides an investment incentive in precisely the wrong area. What Puerto Rico needs is not more and bigger mansions but more commercial and industrial enterprises. There is a disposition with respect to capital gains, and other features too, to entice the American investor by giving him the kind of income tax law to which he is accustomed at home. In the absence of averaging, there is much justification for the complaint that incentives are being prejudiced by the full taxation of capital gains and the failure to carry over capital losses that are not fully offset within the taxable year. However, the adoption of averaging would eliminate this defect in a more equitable manner than would the adoption of the United States income tax provisions.

Income splitting is another issue that has been raised on the basis of the United States example and the urgent need for tax incentives. The Puerto Rican law requires joint returns of husband and wife and even of dependents, except where the dependent income is earned. Income splitting in Puerto Rico would need to rest exclusively upon the incentives provided by lower

marginal rates for married couples because the complex additional considerations which were weighed in the balance in the United States are not present. Tax incentives in the United States did not dominate the argument even if they may have governed the decision. The persuasive argument was focused on discrimination—first, geographic against couples residing in noncommunity property states and, second, against the earned income of such couples. In the practical world where the attainable is valued highly, the consequent relative decrease in marginal rates and taxes of married couples was accepted after a smoky battle of words as a fair price for the elimination of these discriminations. But even for the United States, many are not sufficiently comfortable with this solution of the problem to urge its exportation.

Finally, if the Puerto Rican income tax is to be strengthened to offset the loss of $5.4 million of revenue resulting from the revision of the excises and licenses, the exemptions must be reduced, the rates increased, and important administrative steps must be taken to give practical effect to the paper plans.

Under the recommendations the exemptions would be reduced from $800-$2,000-$400 to $700-$1,400-$350 and the rates would be raised from a range of 12.60-82.95 per cent to the level of the schedule applicable in the United States for 1951, 20-91 per cent. In balancing a tax system little applause is to be anticipated from those called upon to shoulder more rather than less of the burden. Such rates and exemptions would admittedly step on sensitive tax incentive corns. But it is not possible to eliminate business cost excises, the annoyance from nuisance taxes and an overly complex network of licenses, the inequities and the consequent sense of frustration of the will to cooperate with the tax administration, and at the same time to augment and to improve the general services, without placing the tax burden somewhere. Even where it is proper to stress tax incentives, as it is in Puerto Rico, too radical departures from the distribution of tax burden according to taxable capacity should not be tolerated and, indeed, will not be tolerated by an alert electorate. To be administratively effective, the tax system must be fair.

On the administrative side two major reforms are needed. First, the income tax should be put on a current payment basis,. following the general United States pattern. It is now on a two-installment basis, the final payment being due nine months following the close of the taxable year. Second, a system of individual tax accounts should be established for taxpayers of substantial means for the purpose of cross-checking for consistency the data derived from the administration of the income tax, the property tax, the inheritance tax, excises, and licenses. Tax evasion is difficult to detect when the records are departmentalized by government agencies. The tax collector's eye needs to be improved to see around the sharp corners cut by tax dodgers. Also, an income tax cannot be made as equitable as it should be unless the burden of record retention and of arithmetic is assumed by the government. An income tax with the simplest provision for averaging, for example, is still likely to be too complex if it relies upon the individual taxpayer's aptitude and appetite for doing things that come more naturally to government file clerks and operators of automatic calculating machines.

Inheritance Tax

The inheritance tax also has some hitherto unexploited potentialities to promote economic incentives. In general, the existing tax operates like the United States gift tax, except that the cumulation, instead of being on the donor, is on the recipient of property transferred by *inter vivos* gift, inheritance, will, or intestate since March 22, 1946. The rates range from 5 per cent of accumulated transfers not over $2,000 to 70 per cent of gifts over $1,000,000. The exemptions are relatively low.

The tax is alleviated by a vanishing credit, in 5 per cent steps, with respect to property transferred more frequently than once every 20 years; but if the difference in age between the donor and recipient is more than 30 years, this credit is reduced 5 per cent for each year of excess, until at a difference of 50 years the credit vanishes. It is perhaps not surprising that the administrators were less eager to offer than to receive an explanation of the mechanics and theoretical foundation for such relief.

Under the recommendations the transfers would be cumulated on the transferor instead of the transferee, primarily because the estate tax form permits differentiation by type of asset in a manner that can affect the direction of investment in harmony with the government's broad economic objectives. For example, partnership interests or private corporate securities held in areas designated for economic stimulation might be included in the transfer tax base at 50 per cent of their valuation instead of at 100 per cent. Even without an upward adjustment in rates the cumulation on the transferor would result in some increase in revenue, but in this connection it should be noted that property rights in Puerto Rico are governed by community property in the Spanish tradition; at the death of a spouse, one-half of the property is deemed to be transferred, and one-half of *inter vivos* gift is deemed to be made by each spouse. Such splitting of estates militates against the revenue potentiality of a transfer tax even if it is applicable to accumulations upon the transferor.

Property Tax

About two-thirds of the property tax revenue which is collected by the insular government is for municipal purposes. The property tax also accounts for somewhat less than two-thirds of all municipal revenues as against only 5 per cent to 6 per cent of insular revenue.

Puerto Rico has recently completely overhauled its property tax. All property has been reassessed, and assessment has been equalized and upgraded in pursuit of rising prices. A modern administrative organization has been installed. Yet additional reforms seem to be needed to establish the property tax as a more effective instrument of the government's policies in the direction of tax justice and economic development. Special assessments are inadequately employed. While raw materials and certain goods in process are exempt, the property tax still applies to many forms of business personal property. This component of the property tax should be eliminated completely for it is in the nature of a perverse sales tax that falls more heavily on consumers of inelastic

items, usually necessities, than on consumers of luxury items. The revenue loss from such a step would be substantial since the assessed value of personal property is about one-quarter of the assessed value of all property. To recover this revenue loss, an additional property tax mildly graduated in rates applicable above a substantial exemption for smaller property holding is recommended.

The mechanics of the additional property tax are as follows: to the assessed value of directly held property of each individual would be added an amount from interests in partnerships and corporations allocated on the same basis as income from such sources under the income tax recommendations. The tentative tax base for additional property tax would be 3 per cent of this aggregate. From this tentative tax base there would be deducted an exemption of \$225 to arrive at the tax base. The tax would be determined by superimposing such tax base on the taxpayer's income from all other sources and applying the income tax rate as if the additional property tax base were additional amounts of income.

In ad valorem terms the \$225 is equivalent to \$7,500, and under the proposed income tax schedule which ranges from 20 per cent to 91 per cent the property tax rates are equivalent to 0.6 per cent-2.7 per cent. The marginal rates of the combined existing and additional property tax converted to an ad valorem basis become: zero in the exempt area up to \$2,500; 2 per cent for values of \$2,500-\$7,500; and ranging gradually up to 4.7 per cent for the highest income tax recipients and property holders. This new model property tax would be both more equitable and more effective as regards economic incentives than the old style property tax. In any case, the Puerto Rican government, having improved the assessment and administrative machinery, should not long delay stepping up the revenue yield from the property tax. So far the accomplishments have been primarily in the direction of equalization because rates were lowered to compensate for the increase in assessed values, the revenue remaining constant.

The role of property taxation in the revenue system of a modern state is grossly misunderstood, even by some proponents of progressive taxation. The advent of the income tax and inheritance and certain other taxes has not completely undermined the former status of the property tax as an important measure of taxable capacity. It only reduced the importance of its role. The reasons that the property tax must be modernized and utilized as an element of progressive taxation are that the accumulation of wealth proceeded for a long time before the advent of progressive taxes, and, under continuing exemptions or reliefs of various types, continues to accumulate untouched by other progressive elements of the tax system. Ultimately, the entire property tax should be transformed into the new model because only under such a form of property tax can it be supported wholeheartedly on equity and economic grounds.

Insular-Municipal Governmental Relations

Puerto Rico is not alone in its failure to strike an effective balance between efficiency and democracy in the existing

degree of centralization of the functions of government. If local self-government is to be developed, the municipalities must be given greater responsibilities, both for arranging the priorities of local expenditures and for raising the revenues, even at the expense of some financial cost. In terms of existing local functions, which are very minor ones, the costs of local government appear to be excessive, absorbing nearly one-eighth of all governmental revenues.

Decentralization of functions of government would be premature in Puerto Rico pending a full exploration of ways and means to supervise local expenditures more effectively. Perhaps the road to freedom leads first through the revenue side. If local government is to be developed, local government should be made to rely almost exclusively upon two primary sources of revenue, supplements to the property tax and supplements to the income tax. Sharing of insular revenues should be discontinued. This involves the lottery proceeds, the cigarette excise, and the auto license fees. Grants and appropriations would be better than shared taxes, for these would at least have the merit of being adjustable to needs. But they do not breed responsible local government. For this purpose the taxes must be imposed independently by the localities. This is a more difficult political exercise than dispensing charity from insular revenue sources, but it is a healthier form of exercise for building local government.

Conclusions

Such are the highlights of the tax program for Puerto Rico as developed in my report to the Treasurer. It contains recommendations designed to simplify the tax system, particularly the excises and the licenses; to make the collection of the taxes more certain; to distribute the tax burden more equitably; to improve tax incentives for economic development. In direction I am confident that the recommendations are sound; in form that they are sometimes controversial. They should help to stimulate a lively discussion of the issues. Out of the heat comes light, and it is my fervent hope that I will have contributed a little to both. I am confident that the people and government of Puerto Rico are fully capable of recognizing the defects in the counsel offered, arising, if I may be permitted a display of generosity, from my inevitable lack of familiarity with local conditions. And finally, I repeat, not all that ails Puerto Rico is to be found in the realm of public finance.

WHAT PRICE STATE GOVERNMENT?

ROGER A. FREEMAN *

So likewise ye, except ye utter by the tongue words easy to be understood, how shall it be known what is spoken? For ye shall be speaking into the air.

—I Corinthians XIV, 9

THE tremendous growth of federal expenditures has focused public interest in governmental costs almost exclusively upon the federal budget. It is not widely known that state governments spend more of the taxpayers' money than the federal government does for all purposes except the cost of past and future wars.

State fiscal operations are among our best-kept secrets, closely hidden behind a display of "full disclosure." State budgets and accounting reports are filled to the brim with a myriad of details, as meaningful to the layman as would be engineering blueprints of a B-52 or of the George Washington Bridge. What a national magazine said a few months ago of the federal budget —"Nobody except a few of the experts who prepared it will comprehend this budget before it is translated into law." [1]—can be said with equal or greater [2] justification of most state budgets.

By sheer bulk some of the state budgets outweigh the federal budget.[3] For all the meaning they yield to most of those who need and seek information —legislators and the general public— they might, with a few notable exceptions, as well be written in Greek. Yet there is greater need for widespread information on state budgets than on the federal budget because the voters can and do take a more direct hand in state affairs than in national affairs.

State spending programs are often decided by the people themselves through the devices of initiative and

* The author, a corporation controller by background, was called in as fiscal and economic adviser by Governor Langlie of Washington during a state financial crisis in 1950.

1 Editorial in *Life*, February 4, 1952.

2 The federal budget has become somewhat easier to understand since the use of the functional breakdown, the publication of the "Budget in Brief," the gradual change to a "performance type" budget following the recommendations of the Hoover Commission, and, last not least, because "more progress has been made in Federal accounting in the past three years than in the previous thirty." *Journal of Accountancy*, May, 1952, p. 547.

3 The federal budget weights 5¾ pounds, the California budget 7½ pounds, the Washington budget (two volumes) 6½ pounds.

referendum, popular votes on bond issues for veterans' bonuses or capital improvements, and through constitutional amendments which limit certain taxes, earmark others for specific purposes, or even spell out appropriations.[4]

At first glance it might seem that direct legislation—the people governing themselves—will result in sounder legislation. It will—in many cases. Our system of government rests on the belief that the people are capable of judging vital public issues. But the accuracy of their verdict depends on their knowledge of public affairs.[5] Decisions at the polls which do not seem to be in the public interest can almost always be traced to a failure of adequate knowledge, to a lack of available information, to a breakdown in the public relations job of state government. We may wonder how many of those who voted on some constitutional amendments or initiatives were aware of the far-reaching results of the measure. Michigan's constitutional amendment which, on 30 days' notice, diverted 77 per cent of the state's major source of revenue and has brought about large annual state deficits ever since, is a case in point. So is Colorado's amendment setting aside 85 per cent of the sales tax for old age assistance, which in effect related public assistance grants not to subsistence needs but to the yield of the tax. Another example is the welfare initiative passed by the citizens of Washington in November, 1948 which vastly inflated assistance rolls and nearly bankrupt the state. Two years and $220 million later Washington's voters reversed themselves. By that time the damage had been done: a $33 million cash balance converted into a $44 million 'floating debt.'[6] "Lacking interpretive and informative financial reports from which to draw conclusions, we cannot be surprised if the average taxpayer is confused or misled. . . ."[7]

Pointing fingers or bewailing the deficit in the Washington state treasury was obviously of little use. But a thorough job of analysis and public information was called for to prevent a recurrence.[8] The Washington state legislature required three sessions in 1951 to produce a balanced budget. The heated and long drawn-out controversies during those sessions were sufficient evidence that there was a dire need for a factual and understandable fiscal report. Entirely sincere men were making statements which were wholly fallacious. During that time the thousands of letters we received at the governor's office proved that there was also

[4] See, for example, California Constitution, Article IX, Sec. 6, and Article XXV.

[5] Compare: E. Pendleton Herring, *Public Administration and the Public Interest* (New York: McGraw-Hill Book Co., 1936), p. 362. Some theorists disagree, though, as Bishop Wright pointed out recently: "In political life, in the collective life of the civil community this [theory] has taken form of the frequent assertion that problems of expense, bureaucracy and complication of government are beyond the understanding let alone control of individual citizens." (The Most Reverend John J. Wright, "The Philosophy of Responsibility," *Tax Outlook*, March, 1951, p. 5.)

[6] Washington's constitution forbids the incurring of state debts beyond $400,000 without a vote of the people. But the State Supreme Court declared this indebtedness—which at times exceeded $50 million—to be a "casual deficit" and not a state debt. (State ex rel. Troy v. Yelle 192 Wn. 36(2d); see also 33 Okla. 797, 127 Pac. 1065.)

[7] Harold W. H. Burrows, "Understandable State Financial Reporting," *Municipal Finance*, May, 1941, p. 15.

[8] There was another even more generous welfare initiative on the Washington state ballot for November, 1952; it failed. How much of its defeat should be credited to our public information campaign is an open question.

widespread and insistent public demand for such a report. Most of the writers pleaded for increased state support for some activities in which they were interested, or they opposed the taxes necessary to just maintain the services at their present level *or both*.

Newspapers had done a good job under trying circumstances to find their way through the state budget, to explain to their readers the hundreds of millions of dollars expended from 72 state funds by over a hundred departments and divisions. But the scope of state activities had become so widespread, amounts so large, issues at stake so complex, and state accounting so technical that few people were able to grasp the interrelation between the cost of services and their financing. Worst of all, there was no standard or yardstick available by which anybody could evaluate the thousands of multidigit figures or judge the contradictory claims, charges, and denials.

A Report to the Stockholders in "State Government, Inc."

It was clearly the duty of state management to respond to the demand for meaningful information. "Inasmuch as the taxpayer is paying the piper, he can hardly be blamed for preferring a rendition of the melody rather than a copy of the music score."[9] Governor Langlie ordered that a report be prepared "on the whole taxing and spending program of the state. That report should outline what services the state renders its citizens, how much they cost, and how the money is obtained to pay for them. It should also demonstrate how much the citizens of other states spend for the same services. The report should assist our citizens to judge whether they are getting a fair return on their money; to decide whether they want some services expanded, curtailed or eliminated."

The report was completed and published in August, 1952.[10] In planning it we did not aim at a "budget in brief" or the garden variety of "where the money comes from and where the money goes." We tried to pattern it after a shareholders' annual report in which management accounts to the owners for its stewardship and lays the major issues before them. "In twenty-five years the company annual report has changed from a formal, terse, technical, forbidding document to an attractively printed illustrated pamphlet, in some cases still fairly dignified and stately, but ranging all the way up (or down) to rivals of the comic strip."[11] Efforts of the Controllership Foundation, the American Institute of Accountants, contest awards of the "Financial World" and "Forbes" had all contributed to a highly finished and worth-while product. Corporation management realizes that "the assembly of a mass of financial data is of no avail unless the professional or amateur analyst can look past the figures and recog-

[9] Burrows, *op. cit.*, p. 15. Carl Chatters editorialized in the same issue of *Municipal Finance*: "The public should demand and be willing to pay for the type of financial report that will be useful to the government itself for administrative purposes and to the public as a means of checking on the activities of its servants." (p. 3.)

[10] "Your Dollar's Worth of State Government." For copies write to: Office of Director of Budget, Legislative Building, Olympia, Washington.

[11] Thomas H. Sanders, *Company Annual Reports* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1949), p. vii.

nize the major forces which have produced the end result."[12] "Efforts at simplification and popularizing obviously represent a refusal to accept either 'stockholder indifference' or 'stockholder ignorance' as the criterion for the content of the annual report."[13]

"*Why shouldn't the owners of our governmental enterprises—namely the taxpayers—be entitled to the same consideration?*"[14] There is a greater need for citizens to be well informed since they are called upon to take a more direct hand in the policy decisions of their business than the stockholders of the average private corporation. Several states have published abbreviated versions of their voluminous budget books. The Louisiana Department of Revenue, for example, issues reports on revenues and expenditures in the form of comic books. The Illinois Department of Finance prepares condensed quarterly and annual financial reports. Several other states have compiled budgets in brief. By and large, however, state fiscal reports fail to match in informative value the annual reports of major corporations.

Corporation reports center around profits—and generally the higher they are, the better. State reports must focus on taxes and expenditures—and generally the lower they are, the better. How can these reports be made meaningful? What do citizens want to know? What do they *need* to know to form judgments? It seems that there are mainly four questions to be answered:

[12] N. Loyall McLaren, *Annual Reports to Stockholders* (New York: The Ronald Press Company, 1947), p. 281.

[13] Sanders, *op. cit.*, p. 85.

[14] George D. Bailey, "Lessons From Industrial Accounting," *Municipal Finance*, August, 1949, p. 3.

1. How much money does the state spend?
   State fiscal records and reports show the total of all cash disbursements or all transactions going through the state treasury; but what most people ask for is the *cost of state government to the citizen and taxpayer.* That is something entirely different. The cost approach, inherent in commercial accounting, must be adapted to governmental use.
2. Where does the money come from?
   Once it has been determined which activities should be regarded as part of the cost of state government, it is not too difficult to itemize their sources of support.
3. Where does the money go?
   State budgets show how much money each of the hundred or more state officials is authorized to spend and from which of the multitude of funds he gets it. But what we want to know is the cost of the major functions or services for which state government exists: education, public welfare, highways, health and hospitals, development of natural resources, etc. Few state budgets know such a grouping. Only through a laborious process of regrouping and from additional sources outside the state fiscal reports can we obtain that information.
4. What do we get for the money?
   With the exception of the few states which are gradually changing over to a "performance type" budget, state budgets are silent about the "dividends," the return we get from our investment.

How are we to know whether our money was well-spent unless we are shown what it has accomplished?

The most important element, though, without which all these data are meaningless to the lay reader, is a yardstick or standard by which he can measure and judge the figures. *What really counts is not how many dollars Washington or any other state government pays out, but how large a share of the community's income it spends.* The ultimate aim of the report is to pave the way for a sound fiscal policy which will achieve and maintain a proper balance between private and public spending. For that reason we expressed all expenditures of Washington and the other states in percentages of the aggregate income of the residents of the state—the citizen's income dollar.

A Disbursement Total vs. the Cost of State Government

"No single agency knows how much money the state spends in a given year," reported the Washington State Budget Director to the state's Little Hoover Commission. The "Grand Total" in the state budget or the state controller's or auditor's report means forty-eight different things in forty-eight states.[15] It may include large disbursements, which are not state expenses at all, and interfund transfers which are only bookkeeping entries. It usually excludes substantial costs paid from agency funds outside the state treasury. The Grand Total is just the sum of all transactions which under the laws of each state happen to be channeled through the state treasury. Only the U. S. Bureau of the Census has developed a uniform standard for financial operations of state governments. Financial interstate comparisons are well nigh impossible at this time without the use of Census codes, methods, and statistics.

A few facts may illustrate the point. States include in their expenditure totals some or all of the following: (1) Transfer payments from one fund to another; (2) tax refunds (they must usually be appropriated and are shown on the expenditure side rather than as a deduction from income); (3) debt retirement (usually shown in a total which includes interest); (4) repayable loans to finance activities of subdivisions; (5) revolving and trust funds; and (6) self-sustaining insurance or proprietary enterprises.

State accounting reports usually do not include operations financed from so-called agency or local funds. The nature of those agency funds varies from state to state.

Census Bureau statistics on state government finances up to and including 1950 showed largely cost expenditures (including those from agency funds) and also contributions to trust funds and enterprises.[16] We based our interstate comparisons on 1950 data because that was the latest year available at the time we prepared our report; also, 1951 Census figures were established on a new, more comprehensive basis which makes comparisons with earlier years impossible.[17] Because the Census Bureau will use the new method in future

[15] "At the present time state budget systems and accounts present a bewildering diversity when comparisons are attempted," reported the Committee on Uniformity of Reporting Revenues and Expenditures of the National Association of State Budget Officers in September, 1949.

[16] *Compendium of State Government Finances,* 1950.

[17] *Compendium of State Government Finances,* 1951. Within the next year the Bureau may recompute data for earlier years to the new basis.

years, I shall restrict this discussion to the new basis. The Census Bureau now lists all disbursements of agencies and instrumentalities of state governments as state expenditures, including self-sustaining, proprietary and insurance and trust fund operations, and activities of monopoly systems and independent authorities. In that way it gives us a complete picture of all external transactions of the state governmental sector of our economy. This new method is the first major progress in the Bureau's fiscal reporting in ten years.[18] *But the expenditure total shown in the tables is not the cost of state government.* It has at times been mistaken for it because there is an insistent demand for interstate comparisons on the cost of state governments, which cannot even tentatively be satisfied from any other source.[19] This has led to unwarranted conclusions, sensational newspaper stories, acrimonious arguments, and sometimes politically inspired malicious statements.

To use state expenditures as shown in the 1951 *Compendium of State Government Finances* for interstate comparisons on the cost of state governments in the various states,—*and there is at the present time no way to make such comparisons without the use of the Compendium*—we must first make certain adjustments. Those adjustments should eliminate noncost disbursements. One of these is the cost of merchandise purchases of state liquor monopoly systems. The cost of the liquor bought for resale in state stores is an expenditure in the sense that the state expends money for it, but it is not a state expense. The cost of state government does not go up just because the liquor business prospers. The cost of the regulatory function usually exercised by the monopoly system, though, is a true governmental cost which corresponds to a similar item in nonmonopoly states. To show governmental costs, only expenses of liquor monopoly systems incurred for regulatory activities should be included; all other expenditures of the monopoly system should be excluded.

To draw a line between cost and noncost state expenditures is not always as easy as in the case of liquor stores. Legal distinctions are of no help. The rule in the South Carolina[20] and Georgia[21] cases, which was based on a distinction of "governmental functions as distinguished from proprietary functions," seemed to offer a line of demarcation. But the bitterly fought Saratoga case[22] crushed such hopes. Justice Frankfurter summed it up that attempts to find an intelligible criterion for distinguishing between governmental and nongovernmental functions of state governments have been sterile ones, and Chief Justice Stone said, in another one of the four opinions in that case, "'we regard as untenable the distinction between governmental and proprietary interests."

[18] Some of the information now shown was previously not available.

[19] Expense and expenditure are synonymous in the public mind. The distinction (well defined by Lloyd Morey, "Toward a Common Language," *Municipal Finance*, February, 1951, p. 108) is known only to technicians. To avoid misunderstanding we should, in public reports, use terms in their everyday meaning. (See Don Knowlton, "The Semantics of Annual Reports," *Accounting Review*, October, 1947.)

[20] *South Carolina* v. *United States*, 199 U. S. 437 (1905); also *Ohio* v. *Helvering*, 292 U. S. 360 (1934); also *Helvering* v. *Powers*, 293 U. S. 214, 227.

[21] *Allen* v. *Regents*, 304 U. S. 439 (1938).

[22] *New York* v. *United States*, 326 U. S. 572 (1946).

Most states offer workman's compensation insurance in competition with private insurers. Only seven states operate a workman's compensation insurance monopoly. To arrive at fair comparisons, benefit payments and the cost of administration of workman's compensation should be treated not as a state expenditure but as a self-sustaining insurance activity. States generally regard unemployment compensation insurance as a federal activity and exclude it from their financial reports. There is good reason for that because expenditures for benefits and administrative costs are appropriated by Congress and not by the state legislatures; all monies are channeled through and funds are held in the U. S. Treasury, not in state treasuries. Revolving funds for industrial or other activities in state institutions, particularly penitentiaries, are sometimes hard to classify. Some states exclude from their budgets expenditures for which they receive reimbursements in the form of federal grants-in-aid. These amounts are state costs and should be included. Arguments may arise about the inclusion of a number of regulatory and promotional activities—in the industrial, agricultural, or professional fields—which are supported from special licenses and fees, particularly if the funds are not channeled through the state treasury. Those activities should, wherever possible, be shown as state expenditures. The inclusion of toll highways, bridges, or ferries is controversial.

The Census Bureau includes payments for employees' retirement among "Insurance Trust Expenditures." These payments are generally regarded as true governmental costs and should actually figure as a part of general expenditures. Just as a business firm regards Old Age and Survivors' Insurance and Unemployment Compensation contributions as costs of the activity or branch in which they are incurred, government should treat contributions for employees' retirement as true costs. Payments for public school teachers' retirement are undoubtedly part of the cost of education. A comprehensive definition of the "cost of state government"—of the items to be included in totals used for interstate comparisons—probably should not be attempted without the cooperation of a substantial number of the states. An enumerative statement would be of limited value unless it covered a wide divergence of situations in the activities and the budget and accounting systems of the 48 states and unless it was generally acceptable to state fiscal officials.

Lacking uniform standards at this time, we tried to draw the line between *cost* expenditures and *noncost* expenditures as best we could, in cooperation with the Washington State Legislative Auditor; as far as possible we followed the Census code. A reconciliation with the established state accounting is given in the statistical part of the report.

What the Money Goes For

State accounting serves primarily legal requirements. To prevent illegal expenditures or fraud, it records faithfully and completely all transactions. It shows who is authorized to spend the money and what was bought with it, in terms of objects of expenditure like salaries, light and heat, office equipment, etc. It lists the fund from which the money came. Many states operate a hundred funds or more, from which a

like number of departments and divisions draw their support. Obviously, these breakdowns are meaningless to all but those charged with the administration or audit of the funds. There are few states where one can get functional breakdowns from official state reports, though political scientists and accountants seem agreed on the need for functional classification.[23] Functional breakdowns could be produced by cross-tabulating state expenditures at the time they are made and recorded by organization, object, and activity classification.[24] It would be very valuable, not only for popular reports but for budgeting purposes and the information of legislators as well. The Hoover Commission report outlined clearly the need for budgets based on functions, projects, and activities and the ineffectiveness of budgets based only on salaries, supplies, equipment, etc.

Breakdowns by funds and organization units which are obtainable from state budgets and accounting reports are useless for interstate comparisons. No two states use the same system. In commercial accounting some degree of uniformity has been accomplished through the efforts of the New York Stock Exchange, the Securities and Exchange Commission (particularly Regulation S-X and the " Accounting Series Releases "), the Federal Power Commission, the Federal Communications Commission, the American Institute of Accountants and American Accounting Association, the Bureau of Internal Revenue, and the voluntary cooperation of various industries through their trade associations.[25] Financial statements of various companies in a given industry can now be compared on the basis of percentage of gross income or by ratios computed by the various analytical and investment services.

The National Committee for Municipal Accounting which was reactivated in 1949 as National Committee for Governmental Accounting has developed sets of standards, judged municipal fiscal reports, and greatly advanced the accounting and reporting of cities.

State accounting has shown no similar progress. In 1947 the National Association of State Budget Officers set up a Committee on Uniformity of Reporting Revenues and Expenditures. The Committee reported in September, 1949, " it appears that the National Association of State Budget Officers might make a real contribution by promoting standards and principles in budget systems and accounts." Following the Committee's recommendation, the Association granted it permanent status in 1950. The matter rests there. A letter of the Council of State Governments to

[23] See James C. Charlesworth, *Governmental Administration* (New York: Harper, 1951), especially p. 341.

T. Coleman Andrews, " Accounting and the Management of Public Affairs," *Accounting Review*, October, 1947, p. 367:

> Whether one kind of goods or services or some other kind is used by an activity isn't important of itself. Hence, if expense accounting is to be useful to management, its primary objective must be the accumulation and disclosure of activity costs, and the kind of things and services a business buys are of importance only at the activity level, where the need for them, their appropriateness and their cost can be adjudged and the benefits derived from the use of them can be appraised.

[24] " The device of cross-classification which superficially seems incidental and mechanical, is in fact essential for administration and scientific study." Wylie Kilpatrick, " Classification and Measurement of Public Expenditures," *Annals of the American Academy of Political and Social Science*, January, 1936, p. 21.

[25] Roy A. Foulke, *Practical Financial Statement Analysis* (New York, 1945), Chapter XXIV.

me, dated August 18, 1952, states: "Since that time the National Association of State Budget Officers has taken no further action nor entered into any further discussion on this subject. The Committee felt that they were up against an unsolvable problem; that even though Association members might agree on a set of standard account classifications, so many changes of state laws would be necessary that the ultimate goal could not be reached."

It is undoubtedly true that uniformity and simplification "will have to result mainly from action by legislative bodies of government rather than from administrative action by financial officials."[26] But "the financial official cannot conclude that the necessity for demonstrating conformance with statutory requirements prevents his development of summaries of revenue, expenditures, debts and assets for the entire government; that there is no significance in developing recapitulations on an over-all basis that transcend the framework of fund structure and legal requirements."[27] Most important, though: while legislative sanction will be needed for many changes, legislative bodies composed of laymen untrained in governmental accounting cannot be expected to take the initiative. To provide leadership in more informative accounting is clearly the duty of state financial officials.[28] Legislative bodies are traditionally slow to accept far-reaching changes in technical matters unless the technicians are agreed on them and can show the legislators the end product instead of offering merely theoretical discussions. In government, as well as in industry or merchandising, we must first improve our product and display it to our customers before we can sell it to them. Few will buy sight unseen.

At this time the Census statistics are virtually the only source for interstate financial comparisons. But "however useful the product of a central agency like the Census Bureau can be, it cannot substitute for effective local accounting and reporting."[29]

In composing our report we were fully aware of the many shortcomings and pitfalls of interstate comparisons with the means at our command. But we believed that "half a loaf is better than no bread," that progress is achieved by steps, and that such comparisons as we were able to show may stimulate action for better and more accurate procedures.

In the body of the report we detailed expenditures by ten major functions: education, public welfare, highways, public safety, health and hospitals, natural resources, other aid to counties and cities, veterans' bonuses, general control, and miscellaneous. In a statistical supplement we listed the organizational units under each function. Individual fund statements are an essential part of an auditor's report but have no place in a popular report. Depending on circumstances it may be advisable though, even in a popular report, to discuss the general fund or also possibly school fund, highway fund, or whatever fund has important bearings on the state's finances or interests a wider public.

[26] Allen D. Manvel and Robert F. Drury, "The Relation of Governmental Accounting to Financial Reporting," *Municipal Finance* (February, 1951), p. 131.

[27] Manvel, *ibid.*

[28] "The value of an accounting system, whether public or private, depends upon its effectiveness in imparting useful information." Fladger F. Tannery, "State Accounting Procedures," *Public Administration Service* (Chicago, 1943), p. 288.

[29] Manvel, *op. cit.*

How to Measure Taxes and Expenditures

"One set of figures doesn't mean much unless it is thrown up against another set for comparison." [30]

If all these figures on taxes and expenditures are to bear meaning and significance to the lay reader, they must be expressed in magnitudes with which he is accustomed to dealing in everyday life; and they must be held against standards by which he can measure them. The only possible yardsticks in the absence of objective standards are comparisons. McLaren defined as follows the three methods of comparison used in financial statement analysis:

1. Figures relating to items in the same financial statement. . . .
2. Figures relating to the same item in different financial statements of the same company. . . .
3. Figures relating to the financial statements of different companies of similar type for the same period. . . .[31]

Since ratios between figures in the same statement—for example, the per cent of the total budget that goes for each of the various functions—are not meaningful without a standard, there remain basically two sets of comparisons: with prior years, preferably for ten years back or more, and with other states. We used five other western states and the United States average for interstate comparisons.

Dollar comparisons over long periods, whether in gross amounts or per capita, are misleading because the dollar is too fluctuating a unit of measurement. "The financial figures of nearly every company are running to larger amounts than before the war, but that fact taken alone is not fully informative and may be misleading unless set against an appropriate comparative background." [32] The fact that a man pays $100 in taxes today who paid $50 ten years ago has no significance unless we know what his income was then and is now. Per capita state taxes of $100 in 1950 may be a heavier or lighter burden than was $50 in 1940. The only way in which the tax burden can be expressed is in relation to income. "The ratio of taxes to national income is generally regarded the best measure of the over-all tax burden." [33]

What is true of historical comparisons is also true of interstate comparisons. In showing comparative tax burdens (retrospective or interstate), taxes paid were related to state income payments—"income payments to individuals"—as computed annually by the Department of Commerce,[34] and taxes were expressed in per cent of the citizen's income dollar.

The same yardstick was used to measure and compare state expenditures. This gives a truer picture than per capita expenditures. Public expenditures must eventually be paid from the aggregate income of the citizens—mostly through taxes—and are in effect items of expense to each taxpayer. Just as we buy individually food, clothing, and shelter, we buy collectively—through

[30] John Paul Jones, *The Modern Reporter's Handbook* (New York: Rinehart and Company, 1949), p. 281.

[31] McLaren, *op. cit.*, p. 281.

[32] Sanders, *op. cit.*, p. 71.

[33] Lewis H. Kimmel, "Our Tax Burden and Taxable Capacity," *The Annals of the American Academy of Political and Social Science*, Vol. 226, p. 152.

[34] *Survey of Current Business*, August of each year.

taxes—schools, roads, health and welfare services. Just as we may say that we spend, for example, 20 per cent of our income for housing or 30 per cent for food, we can say that we spend 2.5 per cent for education, 1.5 per cent for public welfare, etc.

By expressing taxes and expenditures as a percentage of income, multidigit figures are reduced more effectively than through per capita data. The reader can relate them more easily to himself. The same method is universally used in financial statement analysis: "To facilitate comparisons it is standard practice to express all items as percentages of net sales." [35] Net sales, of course, are the gross income of a company (comparable to the income of individuals) from which all costs of doing business must be paid. If, for example, Sears, Roebuck and Company or Allied Stores compare their expenditures in 1950 with those in 1940, they find that they have increased 233 per cent and 231 per cent, respectively. But they are not likely to express it that way. They will say that expenditures have decreased from 21.8 per cent to 20.7 per cent of gross income in the first case, from 32 per cent to 27.2 per cent in the second case.

If we compare the expenditures of the 48 states in 1940 and 1950 dollarwise, we find that they have gone up steeply. We know that the population has increased and the value of the dollar has shrunk. So we apply the population and price indexes to the 1940 data. The population of the United States rose 14.5 per cent between 1940 and 1950. The price index of goods and services purchased by state and local governments reached 200.2 per cent in 1950 (taking 1940 as 100).[36] We would then expect state expenditures to have risen 129 per cent between 1940 and 1950. Actually they rose 173 per cent. That makes it seem as if state expenditures had risen out of proportion. But did they? In the same decade retail sales jumped 212 per cent, private construction 268 per cent. Income payments rose 180 per cent, the private money supply 168 per cent. Those increases were in part the result of greater productivity which directly affects public income and expenditures as well as private. It has been estimated that productivity rose about 2 per cent per year. If we apply that factor—in addition to the population and price factors—to state expenditures in 1940, we would expect an increase of 179 per cent which is very close to the actual rise of 173 per cent. In 1940 the 48 states spent 6.15 per cent of the income of their citizens, in 1950, 6.03 per cent.[37]

An equally strong case can be made for using per cent of income rather than per capita as a basis for interstate comparisons. Per capita income in 1951 varied between \$771 and \$2,076 among the 48 states, a spread of 100:269. Valid comparisons of dollar expenses could hardly be made of a man earning \$3,000 with one making \$8,100 a year, or of two department stores with a sales volume of \$100,000 and \$269,000 respectively. But the expenses of the two men or the two stores could be compared by expressing them in percentages

[35] McLaren, *op. cit.*, p. 290.

[36] Implied price deflators from *Survey of Current Business*, July, 1952, p. 28.

[37] Because state fiscal data are reported for fiscal years which end June 30 or earlier, we related them to the income for the preceding calendar years.

of their income or sales volume. The general income level in a state largely determines wage levels and thus state costs. Of the 15 states with the highest per capita income in 1951, 11 were paying the highest average teachers' salaries. Of the 15 states with the lowest per capita income, 10 were paying the lowest average teachers' salaries. States with high per capita income do not necessarily pay the highest public assistance grants, but poor states usually pay low grants. Eight of the 10 states which in December, 1951 paid the lowest old age assistance grants ranked among the 10 lowest per capita income states.[38]

What these figures bear out is that public expenditures—just like private and business expenses—follow income and should be measured by it.[39] " It has long been recognized that the extent and character of governmental functions have been strongly influenced by the long run upward trend in national income." [40] " The general income of the people from which the income of the state in a large measure arises, should as a matter of right and does as a matter of fact, exert a decided influence upon the extent and character of the functions which the state may undertake." [41]

[38] " Social expenditures are relatively larger in wealthy communities where the objective need is less than in poor communities." Gerhard Colm, " Theory of Public Expenditures," *The Annals of the American Academy of Political and Social Science*, Vol. 183, p. 7.

[39] " The growth rate of per capita income dominates that of governmental expenditures." Joseph H. Spengler, " Prospective Population and Income Growth and Fiscal Policy," *National Tax Journal*, March, 1950, p. 52.

[40] Lewis H. Kimmel, *Taxes and Economic Incentives* (Washington: The Brookings Institution, 1950), p. 9.

[41] Henry C. Adams, *The Science of Finance* (New York: H. Holt and Company, 1908), p. 27.

One word of caution, though—we can no more judge a state's expenditure program by one figure than we can conclusively rate a business concern by one ratio. Dun and Bradstreet regularly compute for various industry lines fourteen ratios ranging from " net profits on tangible net worth " to " inventory to net working capital " and " funded debt " to " net working capital." Security analysts use a whole battery of other ratios to evaluate the wisdom of investing in certain industries or individual stocks. For practical purposes, however, we need a rule of thumb—one yardstick around which additional information can be grouped. That one rule may, in the case of a credit man, be " current assets to current liabilities "; of a management man " net sales to cost of goods sold " or " overhead to net sales "; of a merchandise man " inventory to net sales "; of an investor " net earnings to market price." To compare state fiscal operations by size, the ratio between the income of the citizens and taxes and expenditures seems the most workable one. To judge how wisely or efficiently the taxpayers' money is spent, we need many more data.

Limitations of Interstate Comparisons

So far, we have been talking about *state* expenditures and *state* taxes only. We know that the division of responsibility for public services between states and their political subdivisions varies greatly. Certain health, welfare, educational, or highway services may be performed by state government in some states, by counties, cities, school or other special districts in others. Activities of local governments may be wholly locally financed or receive state support in the form of grants-in-aid,

shared taxes, or participation in the profits of state enterprises. The shift of financial responsibility for public services from the local level to the state has been universal over the last twenty years. But it has gone farther in some states than in others.

On the average, local governments contributed 22.1 per cent to the joint state-local public assistance cost in 1951. But in 17 states they contributed over 30 per cent and in 5 states more than 50 per cent. On the other end of the scale, local governments contributed less than 5 per cent in 12 states.

In 1950 states provided on the average 42.2 per cent of the support of public schools. In 11 states schools received more than 60 per cent of their revenues from the state, in 18 states less than 30 per cent. Likewise, the division of the road mileage, whose construction and maintenance are supported from state or county and city funds, varies greatly among the states. These examples may suffice to illustrate the point: taxes and expenditures in a particular state may appear low because counties, cities, and school districts largely finance themselves locally; in another state expenditures may seem high because state revenues support a substantial part of the activities of local governments. To gain a true picture of taxes and expenditures in a state—particularly for interstate comparisons—we must add state and local figures.

Unfortunately, local data are only partially available. The Bureau of the Census used to take a "census of governments" every ten years. That census provided comprehensive financial data for states and their political subdivisions. The last such census was taken in 1942. In 1950 the 81st Congress ordered that the census of governments be taken every five years, starting with 1952 (Public Law 767). The 82d Congress, however, eliminated the $2¼ million appropriation for the 1952 Census of Governments. There is now no statutory authority to undertake such a census or request appropriations for it until 1957. The 1953 budget forced the Governments Division of the Census Bureau to reduce its staff to less than what it had been since the mid-thirties. This makes it barely possible for the division to carry on its most essential routine activities. There seems to be no hope now of having comprehensive state and local tax and expenditure data for the next five years.

Close estimates of taxes can be made, however, with the help of available data. State tax collections are known. Local property tax data are available from 41 states; they can be estimated for the other seven states. Sample tabulations of the Census Bureau indicate that state taxes and local property taxes account for 94 per cent of all state and local taxes;[42] local nonproperty taxes account nationally for the other 6 per cent. Complete data on local nonproperty taxes are available only for the 474 cities over 25,000 population.[43] They account for 75 per cent of the nonproperty taxes collected by all local governments. Thus we are able to obtain a state-by-state picture of 98.5 per cent of all state and local taxes.[44]

[42] U. S. Bureau of the Census, *Governmental Revenue in 1950.*

[43] U. S. Bureau of the Census, *Compendium of City Government Finances in 1950.*

[44] R. A. Freeman, "The State and Local Tax Burden in 48 States," *Pacific Northwest Industry*, January, 1953, p. 91; also, *State Government*, April, 1953.

Summary for 48 States:

	(Millions of dollars)			
1950 State Taxes			$ 7,930	50.1%
Local property taxes	$6,997	44.3%		
Local nonproperty taxes in major cities	647	4.1		
Other local nonproperty taxes	239	1.5		
			7,883	49.9
			$15,813	100.0%

The only item of which we have no state-by-state breakdown amounts to $239 million or 1.5 per cent of all state and local taxes. Even an unequal distribution of the 1.5 per cent could not materially affect the over-all picture. Comparison of the tax burden in the various states should be made only on the basis of a total of state and local taxes. To consider state taxes alone leads to fallacious conclusions.

No comprehensive data are available for local expenditures. Fiscal reports of counties, cities, school, road and other districts are available in many states. An attempt to total them, though, would be of no avail because those governmental units vary widely in their treatment of utilities (enterprises), revolving, trust, and sinking funds, inclusion or exclusion of some activities or funds, and in the classification of expenditures. In a few fields, national agencies have collected expenditure statistics which include both state and local data. The Federal Security Agency gathers public assistance expenditures. The U. S. Office of Education and the National Education Association publish educational statistics, the U. S. Bureau of Public Roads publishes highway statistics. So, we have statistics in some fields like public schools, public assistance, or higher education. But for the time being we do not have state-by-state totals of the expenditures of state and local governments. Some day, if Congress appropriates the funds for the gathering of the data, we may again have a comprehensive picture of the spending of our state *and* local governments.

What Do We Get for the Money?

The high point of a company's annual report is the chapter in which management proudly talks about earnings and dividends, the return its stockholders get on their investment. If the whole report had to be boiled down to the one paragraph closest to the reader's heart, it would be the paragraph that tells the dividend story.

State fiscal reports faithfully relate state expenses and total up the taxes from which they were paid. Hardly ever do they tell us whether we get a return on our investment in state government. Judging by the reports, we might assume that all the money that goes to state government is a complete loss, just "poured down the drain." Small wonder that we tend to judge success or failure of an administration exclusively by the amount of money it expended, that we forget that what counts is not only the size of our investment but the size of the return on it. The return we receive for taxes in the form of services or improvements cannot be expressed in dollars and cents as easily and accurately as dividends on common stock. This makes it even more important to present as complete a picture as possible. Two-thirds of the Washington report (64 pages) is devoted to a description of the services rendered by the state so that the reader

may judge which activities he regards as essential and which he would like expanded, curtailed, or eliminated. The dividends of government are manifold —children educated, aged and disabled supported, handicapped made self-supporting, roads constructed and maintained, patients in hospitals cared for or cured, roads patrolled and accidents prevented, forests protected from fire losses, etc. "Since the appropriations are no measure of the success of services rendered by the budgetary unit, a possibility exists that some method of correlating services rendered with appropriations eventually will be secured. This has been accomplished in general accounting by comparison of revenues with costs to determine whether the enterprise is profitable." [45]

For most state governmental activities, cost accounting is still but a gleam in the eye of an ambitious budget analyst. We can compute unit costs with more or less difficulty: how much it costs to educate a child, to maintain a patient in a hospital, to build a mile of concrete road, to process a tax return, to issue a driver's license, to protect 100 acres of forest land, or to patrol 100 miles of highway. But all these figures do not mean very much unless we can compare them with similar data from other states. Without agreement on the items which go to make up those costs, without established standards of quality, the validity of comparisons can be seriously challenged. "Comparative costs of maintaining inmates in institutions and other functional costs are not now reported on a consistent basis in the several states. . . ." found the National Association of State Budget Officers in 1947, and resolved, "For such use as any of the states may desire to make of them, some standards of state budgetary and accounting principles would be valuable. The National Association of State Budget Officers adopts as a major project the improvement of financial reporting and the formulation of standards." Unfortunately, the project was not undertaken, despite its importance for intelligent budgeting.

Alert budget units in a few states have made creditable attempts to create cost standards. But not until *uniform* definitions and standards are accepted and used in a large number of states will it be possible to express administrative efficiency in cold figures rather than narrative descriptions.

In our first ambitious planning we envisaged comparative cost figures for many activities. We found out that the long and laborious job of setting up cost accounting methods from headquarters and stimulating thinking along cost and return-on-investment lines in the departments must precede such expectations.[46] To make activity accounting a living thing, it must be built into a system of "performance budgeting." In Washington barely a start has been made with the unit costing of a few activities. For the report at hand we had to be satisfied with a limited number of comparative data and fill them in with narrative descriptions.

[3]Reviewers sometimes use the ratio between administrative expenditures and the program amounts (tax collections or program expenditures) as a test of efficiency. This may be misleading. As a rule, one should be careful of the

[45] Leo Herbert, "Comparison between Governmental and General Accounting," *Accounting Review*, October, 1948, p. 400.

[46] Compare the excellent article by Perrin Stryker, "P & C for Profit," in *Fortune*, April, 1952, p. 128.

"prevalent comparisons of administrative efficiency in terms of collections or dollars of revenue. If one man in the state capitol sat there and did nothing but deposit the money that came in in response to some tax law on the books, if he used no clerical help at all, used no auditors, no investigators, no other aid in the administration of the law, he could collect a great amount of money from a great proportion of the citizens who would voluntarily and freely obey the tax law, and the only expense you would have in connection with the administration of that tax law, would be the salary of the gentleman sitting in the state capitol."[47] The administration of public assistance and many other activities could be made "inexpensive" by omitting all safeguards, control, or enforcement. Savings thus achieved would, of course, be fictitious and rather costly to the taxpayers.

We must also be careful in accepting the ratio between the number of state employees and the state population as a test of efficiency of an activity unless we can also relate it to extent, quality, or intensity of the service rendered. The example of the tax administration by "one man depositing the checks" or public assistance administration by a "clerk accepting applications and writing benefit checks" may be sufficiently illustrative. There is simply no way to measure governmental efficiency without thorough cost accounting.[48]

"The Art of Readable Writing"[49]

The first thing we have to do in planning a state's popular fiscal report is to decide for whom we want to write. No other question will start so many controversies in the group drawing up the blueprints and writing specifications; that is why the group should be kept as small as possible. As a general rule, we should not underrate the reader's intelligence nor overrate his knowledge. It's a hard nut to crack, to appeal to groups widely different in education, interests, political philosophy and understanding without being charged with oversimplification by some, with being technical and dull by others. We may as well recognize that we cannot compete in popular entertainment value with a murder mystery nor in detailed information with a six-pound budget book. We tried to appeal to as wide a group as possible by starting out with a general section (16 pages) telling the basic story of the state's development and finances. That chapter, richly illustrated with graphs, is the real core of the report. We then described in 64 pages the services rendered by the various departments and institutions, with some graphs and many photographs. Activity shots provide more human interest than views of buildings. The copy submitted by departments usually tends to describe

[47] Charles F. Conlon, "The Auditing of Income Tax Returns," *Proceedings of the 39th Annual Conference on Taxation (1946)*, National Tax Association, p. 133.

[48] Caution must be used when comparing the number of public welfare employees in the various states. Employees of county welfare departments are state employees in some states, county employees in others though they perform the same function—namely, field administration of the four categorical (federally-supported) public assistance programs, child welfare services, general public assistance, etc. Adjustments must be made by using statistics of the Federal Security Agency.

[49] With apologies to Rudolf Flesch, *The Art of Readable Writing* (New York: Harper and Brothers, 1948).

what they do and how they do it rather than the service the public gets. Sometimes their enthusiasm runs away with them and has to be toned down. The customary beginnings of departmental descriptions, i.e., "the xyz department is divided into three divisions . . ." or "the xyz department was created by Chapter 1234, Laws of 19 . . . ," are deadly. A complete rewrite is almost always necessary.

To define the meaning and import of a program in terms of human values calls for imagination and a job of creative writing. There is no better way to dramatize it and bring it close to the reader than by telling the story of Joe Doakes who went to the reformatory, or the hospital, or the rehabilitation center—if you have the space to do it. Attractive cover, art and lay-out, just like the wrapping of merchandise, may mean the difference between wide or limited readership. A two-color job is worth the difference in cost.

We filled the last 16 pages with statistics on population, income, taxes, expenditures, and operating data on schools, welfare, highways, etc. They can do no harm there by scaring off average readers, but they serve important reference needs of students of government, civic groups, etc.

The newspaper organization of the state expressed strong interest in the project from the beginning. It requested—and we gave all daily newspapers and the wire services—the advance copy of all chapters and mats of most graphs. They published the story literally or in condensed form in installments before the booklet was completed and released to the public. The state association of broadcasters asked for a condensed version suitable for 15-minute broadcasts.

By the time the booklet was ready for distribution, we were flooded with requests. Many civic organizations, chambers of commerce, and service clubs asked for substantial numbers of copies for their local branches or individual members and made it the subject of discussion programs. Schools started using it as a text in their social science classes. Several universities in a number of states asked for the booklet in quantities to be used in classes in accounting, public finance, government, and public relations. The first printing of 25,000 copies was exhausted within two months.[50]

Conclusion

Ill equipped as state accounting is to serve the informational needs of the public, it supplies the basic material from which meaningful reports can be prepared. Until such time as the states themselves develop and apply uniform standards and use a cost approach, we must, by and large, follow the methods and statistics of the Bureau of the Census.

A state report, if understandably written and attractively done, can find wide readership and public acceptance. What can it accomplish? Obviously a report as such will *not* balance the budget, cut taxes, or provide more support for the schools; but it can raise the public controversy over these subjects to a more intelligent level. It can provide a common factual basis for the thrashing

[50] For more details of the public impact, see "State Government Reports to its Shareholders," *Public Relations Journal*, April, 1953.

out of opposing views stemming from divergent political philosophies. It can help to limit the opportunities for ambitious politicians to create myths and to play upon ignorance and prejudice.

I should like to discuss briefly just two of the most frequently used myths.

Myth No. 1. An often-heard promise, certain to find no objection, is usually to eliminate waste and duplication and, with the money saved, cut taxes or (and) build schools, hospitals, or what have you. No doubt a great deal of waste, overlapping, and duplication exists in state government. A thorough overhaul of the anachronistic structure of most of our state governments has long been overdue. Integrated management of state affairs could, in the long run, save many millions of dollars, not through large-scale reduction in the size or cost of top management but through better program administration.[51] "The attempt to sell administrative reorganization legislation on the basis of tax reduction, however honorable the motives and however laudable the hopes of those who support administrative reorganization for that reason, is a snare and delusion. . . ."[52] Since more than four dollars out of every five which the states spend go for education, health and welfare, and highways, the consensus of opinion of our citizens as to whether they want more or fewer of these services supplied free by the state will set the size of the budget. "There is no royal road, no painless way to governmental economy."[53]

Myth No. 2. "There are too many bureaucrats and clerks and they are overpaid." Nothing is more popular than the promise to fire many of them and reduce taxes. The state payroll accounts on the average for less than one-fifth of all state expenses.[54] A reduction of state payrolls by 10 per cent would cut the budget by less than 2 per cent. A 10 per cent reduction in personnel in the fields of tax or welfare adminstration, patrolling or planning

51 ". . . It has been demonstrated over and over again in large organizations of every type in business and in government that genuine savings in operation and true economies are to be achieved only by the provision of adequate managerial machinery which will afford opportunity for central executive direction to pursue day after day, and year after year, in season and out of season, the task of cutting costs, of improving service and of raising the standards of performance." (The President's Committee on Administrative Management, *Administrative Management in the Government of the United States*, p. 51.)

The Council of State Governments summed it up: "Although an immediate reduction in total expenditures is not expected to take place as a result of reorganization, it has become clear that more efficient organization will give the taxpayer the greatest value for every tax dollar spent." (*State Reorganization in 1950*, p. 1.)

52 Rowland Egger, "Painless Economy and the Mythology of Administrative Reorganization," *Proceedings of the 42nd Annual Conference on Taxation, 1949*, National Tax Association, p. 490. Compare also, "Although organizational and administrative improvements can bring about certain savings or better work performance, it seems likely that major reductions in governmental costs will be achieved only by substantially reducing the number of services or activities which government performs." (*3rd Report of the Oregon Legislative Interim Committee on State Government Administration*, February 16, 1951, p. 13.)

Further, "Although the Committee feels that considerable savings will be realized from the adoption of its recommendations, the recommendations if carried out, will show up principally in the form of better government with its resultant benefits to the people rather than in wholesale cuts in state expenditures. Wholesale reduction in government costs is largely a matter of curtailing services. . . ." (*2nd Partial Report, California Senate Interim Committee on Governmental Reorganization 1951, Regular Session*, p. 15.)

53 Egger, *ibid.*

54 More than half of a state's expenditures go for the support of individuals (public welfare) or local governments.

and maintenance of highways, forest fire protection, or hospital care could have detrimental effects upon the programs and cost many times over the savings on the payroll. Many governmental operations probably use more employees than an efficient private company would need to do the same job. Besides the realities of political life, the major reason is the fact that state governments cannot compete with private business for administrative talent. State (and also federal) salaries in the lower grades compare favorably with those in private employment, but there are not enough capable administrators in the middle and upper grades willing to sell their services to the state (or federal) governments for fifty cents or less on the dollar. Until this situation is corrected, we may as well accept the fact that state offices on the average will need more employees than would comparable business offices.

"The plain fact is that the only way to save significant sums of money . . . is to eliminate activities and reduce the scale of operations." [55] The main lesson a state report can and should drive home is that taxes are payments for services and that the way to reduce the bill is to order less. Few would think of entering a store and ordering goods without being willing to pay for them. The mushroom growth of the grant-in-aid system has probably done more than anything else to hide the relation between services and their costs, between the receipt of benefits and the obligation to pay for them. It has done a great deal to create the "something for nothing" attitude.[56]

"What is really needed is a movement to make the public 'spending conscious' by showing the relationship between government revenues and expenditures." [57] Popular state reports may go a long way toward that objective.

If I were to express the aim of our report in one paragraph, I should do it with two quotations. One is James Madison's famous—"A popular government without popular information, or a means of acquiring it, is but a prologue to a tragedy." The other is from John P. Jones's "The Modern Reporter's Handbook" [58]—"People like statistics—if they can understand them." If they do not understand yours—blame yourself, not the people.

[55] Egger, *ibid.*

[56] "More money can be wasted in the distribution of centrally collected funds than in almost any other device yet developed in the tax system." —Harold M. Groves, "A General Appraisal of the American Tax Problem," *The Annals of the American Academy of Political and Social Science*, Vol. 266, p. 51. In the same issue, p. 20, "State and Local Finance," Robert S. Ford said: ". . . there are potential dangers in grants insofar as they tend to stimulate extravagant expenditures—by supplying the funds without discernible burden to local taxpayers—and to undermine local responsibility. Furthermore, grants may lead to over-expenditure for the particular function receiving assistance."

[57] Alfred G. Buehler, *Public Finance*, New York, 1940, p. 207.

[58] New York: Rinehart and Company, 1949, p. 280.

THE DECLINE OF THE GENERAL PROPERTY TAX

MABEL NEWCOMER *

THE general property tax was the largest single source of tax revenue in the United States for most of the country's history before World War II. As late as 1932 it was contributing more than half of all federal, state, and local taxes combined. In recent years, however, both the corporation and personal income taxes have far exceeded the property tax as revenue producers; and in 1950 the property tax contributed only 14 per cent of all tax revenues.

The recent history of the general property tax is unique in that this is the only important tax in the United States that has not increased markedly in yield during the past twenty-five years. In fact, property tax revenues declined during the early thirties and only in 1947 did total levies exceed those of 1930. At the same time complaints of excessive property levies continue; and municipalities are feverishly searching for new sources of revenue both to " relieve real estate " and to meet threatened deficits.

In view of the acute financial problem in many of our cities, it is of particular interest to learn whether the relief that has been granted to property owners in the past twenty years is reasonable in relation to present day demands. The present study is an attempt to trace the changes in the general property tax during this period in the hope that it will throw some light on this question.

Changing Importance of Property Taxes in the Tax System

State and local expenditures increased eightfold between 1902 and 1932, and these rising costs were met largely from increased property tax levies. There was no comparable increase in the potential tax base. National Bureau of Economic Research estimates show an increase in this same period in the national wealth of between three and four times.[1] The inevitable result was that property levies increased out of proportion to the value of the property taxed. During the 1920's there were frequent protests that property was bearing " more than its share " of the tax burden. These complaints were sharpened by the depression, and political pressures together with the breakdown of collection procedures led to a gradual reduction of property tax levies.

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[1] *Studies in Income and Wealth* (New York: National Bureau of Economic Research, Inc., 1951), XIV, 18-19. The estimates are $81 billion in 1900, $102 billion in 1904, and $299 billion in 1932.

State and local governments did not respond to the depression quickly with reduced tax levies. The unprecedented demand for relief expenditures fell in the first instance on local budgets, and few local authorities were in a position to borrow extensively. On the contrary, those municipalities that had already taken full advantage of their borrowing powers were forced to reduce their debts in the face of a decline in the assessment rolls to which debt limits were frequently tied. Consequently, the levies of 1932 exceeded those of 1929 in a number of states. The high point of property tax levies for all states combined came in 1930. This was followed by five years of declining levies, and in 1935 the total stood at less than 80 per cent of the 1930 peak. Property taxes have risen fairly steadily since 1935, but so slowly that only in 1947 did they exceed the high point of seventeen years earlier. Detailed figures of trends are given in Table 1.

The first and obvious reason for the relative decline of the property tax is the enormous expansion of federal taxes. Federal tax revenues, in which the general property tax plays no part, are approximately three times the combined collections of state and local governments today, whereas twenty years ago they were less than one-third of state and local collections. But disregarding federal taxes, the general property tax revenues of state and local governments declined from 75 per cent of all tax revenues in 1932 to 42 per cent in 1950.

The second reason for the declining importance of the general property tax is that most of the state governments today levy only nominal sums or none at all for their own purposes. At the beginning of this century only two states obtained no state revenues from the property tax, and for all states combined it produced more than half of their tax revenues. In the first quarter of the century a number of states attempted to do without it in order to give local governments full benefit of this source, but most of these reverted to state levies after a few years, and only three were not using it in 1926. Total state revenues from the property tax in this year were approximately five times what they had been at the beginning of the century, although state tax revenues as a whole had grown much faster, and three-quarters of the states were obtaining less than half of their tax receipts from this source. New sources of state revenue—personal and corporation income taxes and motor fuel and motor vehicle license taxes—were providing the states with more revenues than the property tax.

In the second quarter of the century, these and other new sources, including the general sales tax, employment tax, tobacco, and liquor taxes, made it possible for most states to reduce their property levies greatly or to abandon them altogether. As a result, total state levies dropped to less than half of their 1926 level and to less than 2 per cent of all state tax revenues. Also, they decreased from 8 to 2 per cent of all property tax levies. The property tax is, for all practical purposes, a purely local tax today. There seems to be every reason to expect this trend to continue. State aid to local governments has increased in many ways, and with all the other taxes available to the states it is hardly reasonable for them to levy taxes on the one base on which local governments depend for the larger

TABLE 1

COMPARISON OF STATE AND LOCAL TAX REVENUES FROM GENERAL PROPERTY TAX LEVIES AND OTHER SOURCES FOR SELECTED YEARS, 1902–1950 *

(Dollar figures in millions)

Year	State and Local Taxes			State Taxes			Local Taxes		
	All	Property Tax	Per Cent from Property Tax	All	Property Tax	Per Cent from Property Tax	All	Property Tax	Per Cent from Property Tax
1902 ..	$ 846	$ 700	82.7%	$ 149	$ 76	51.2%	$ 698	$ 624	89.5%
1912 ..	1,609	1,355	84.2	305	145	47.4	1,305	1,210	92.8
1922 ..	4,139	3,316	80.1	861	344	40.0	3,278	2,971	90.7
1926 ..	5,404	4,326	80.0	1,254	364	29.0	4,150	3,962	95.5
1927 ..	5,738	4,554	79.4	1,353	363	26.8	4,385	4,191	95.6
1928 ..	6,207	4,855	78.2	1,511	368	24.3	4,696	4,486	95.5
1929 ..	6,481	4,993	77.0	1,594	336	21.1	4,887	4,657	95.3
1930 ..	6,863	5,186	75.6	1,777	338	19.0	5,086	4,848	95.3
1931 ..	6,734	5,068	75.3	1,787	357	20.0	4,948	4,711	95.2
1932 ..	6,371	4,792	75.2	1,671	317	19.0	4,700	4,475	95.2
1933 ..	5,923	4,279	72.3	1,698	247	14.5	4,224	4,033	95.5
1934 ..	6,060	4,113	67.9	1,969	229	11.6	4,091	3,884	94.9
1935 ..	6,340	4,090	64.5	2,206	195	8.8	4,134	3,896	94.2
1936 ..	6,844	4,121	60.2	2,612	180	6.9	4,232	3,940	93.1
1937 ..	7,390	4,198	56.8	3,103	195	6.3	4,287	4,004	93.4
1938 ..	7,979	4,280	53.6	3,595	185	5.2	4,384	4,095	93.4
1939 ..	8,076	4,304	53.3	3,616	173	4.8	4,460	4,131	92.6
1940 ..	8,721	4,368	50.1	4,171	165	3.9	4,550	4,204	92.4
1941 ..	9,072	4,372	48.2	4,498	154	3.4	4,574	4,218	92.2
1942 ..	9,614	4,446	46.2	4,972	183	3.7	4,642	4,263	91.8
1943 ..	9,743	4,453	45.7	5,094	175	3.4	4,648	4,278	92.1
1944 ..	10,109	4,504	44.6	5,407	168	3.1	4,701	4,336	92.2
1945 ..	10,439	4,654	44.6	5,603	199	3.6	4,835	4,455	92.1
1946 ..	11,108	4,878	43.9	6,014	169	2.8	5,094	4,709	92.5
1947 ..	12,415	5,350	43.1	6,745	158	2.3	5,670	5,192	91.6
1948 ..	14,404	6,079	42.2	7,793	155	2.0	6,611	5,924	89.6
1949 ..	15,681	6,671	42.5	8,364	152	1.8	7,316	6,519	89.1
1950 ..	16,710	7,090	42.4	8,940	160	1.8	7,770	6,930	89.2

* Data for total state and local taxes have been taken from the various reports of the Bureau of the Census on governmental finances, insofar as these are available. For local taxes it has been necessary to supplement these from a variety of sources. Official state reports have been used as far as these publish such data. In addition, the estimates of the National Industrial Conference Board in their studies on the *Cost of State and Local Government*, statistics published in various editions of *Tax Systems of the World*, and the reports on *Tax Yields* of the Tax Institute have been used to supply missing data. For recent years some unpublished data have been obtained from letters from state finance officials, and, where no other data could be found, estimates were made based on *Financial Statistics of Cities* and other incomplete data. For the property tax itself it was often necessary to use levies rather than collections. When levies were substituted for collections for a specific state, they were used for that state for each year in the series so that trends would not be distorted by shifting from one to the other. Also, where levies were substituted, they were credited to the fiscal year in which payment was due. The result is to overestimate the percentage from property taxes in years when collections lag and to underestimate it in years when back-tax collections are large, but this should not affect appreciably the long-term trend. General property tax figures differ somewhat from those of the Bureau of the Census in the years when total levies and collections are reported because of the necessity of using levies for some states and collections for others throughout the period given. Also, this study is concerned with property taxes that are, except for tax limits, levied at the discretion of local governments. Consequently, when intangibles or other property are withdrawn from the general property tax base and taxed at a low uniform rate throughout the state, the proceeds have not been included under general property taxes, whether these revenues accrue to state or to local governments.

part of their financing and then to redistribute this money in the form of state aid. There are more effective ways of equalizing resources.

Local governments are so dependent on the property tax for independent revenues, and at the same time are so hedged in by state limitations on this source, that the scope of their activities is in large measure determined by this tax base. It was inevitable that local levies would decrease with the decline in property values, and almost equally inevitable that they would increase again with rising property values. But in spite of recent increases the general property tax has declined in relative importance in local finances as well as in state finances. This has been made possible largely because of increases in state and federal aid. Nonproperty taxes have grown somewhat in importance in local financing in recent years, but they were a smaller proportion of total local revenues in 1950 than they had been in 1902. These trends are shown in Table 2.

The larger cities have obtained approximately the same proportion of their revenues from the property tax as have municipalities as a whole during this period. If the proportion of property taxes and special assessments (which are levies on much the same base as property taxes and which are little used outside of the larger cities) is compared for 1932 and 1950, the decline is found to be from 84 to 54 per cent. The cities have been able to increase their revenues from other taxes much more than have local authorities, and they are less dependent on state aid. However, even the cities are obtaining more from state and federal aid than from independent nonproperty taxes. This is shown in Table 3.

TABLE 2

PRINCIPAL SOURCES OF LOCAL REVENUES

1902–1950 *

Source	1902	1932	1942	1950	1951
			Millions of Dollars		
General property tax †	624	4,221	4,273	7,042	7,580
Other taxes †	82	382	359	942	1,041
State and federal aid	58	619	1,795	4,241	4,424
Charges and miscellaneous	89	790	613	1,602	1,871
Total	853	6,015	7,040	13,827	14,916
			Percentage Distribution		
General property tax	73.2	70.2	60.7	50.9	50.8
Other taxes	9.6	6.4	5.2	6.8	7.0
State and federal aid	6.8	10.3	25.5	30.7	29.7
Charges and miscellaneous	10.4	13.0	8.7	11.6	12.5
Total	100.0	100.0	100.0	100.0	100.0

* Data from Bureau of the Census reports on governmental revenues.

† These figures differ from those in Table 1 since the Census Bureau figures include all property taxes, general and special. Also, the estimates based on individual state reports differ from Census estimates as explained in the footnote to Table 1. The differences are not great enough, however, to affect the trends indicated.

TABLE 3

Principal Sources of Revenue in Cities with a Population of 25,000 and Over *

Source	1902	1932‡	1942	1950
	Millions of Dollars			
General property tax	270	1,659	1,668	2,324
Other taxes	41	151	245	704
State and federal aid	17	121	462	908
Special assessments	26	155	32	65
Charges and miscellaneous †	16	80	150	416
Total	370	2,166	2,557	4,417
	Percentage Distribution			
General property tax	73.0	76.6	65.2	52.6
Other taxes	11.1	6.9	9.6	15.9
State and federal aid	4.6	5.6	18.1	20.5
Special assessments	7.0	7.2	1.2	1.5
Charges and miscellaneous	4.3	3.7	5.9	9.4
Total	100.0	100.0	100.0	100.0

* Data from Bureau of the Census, *Wealth, Debt and Taxation*, and *Financial Statistics of Cities*.

† This is the classification used by the Bureau of the Census for recent years except that special assessments have been separately listed. It includes charges for current services, contributions from enterprises, and miscellaneous. For earlier years the nearest approximation to this that could be obtained, in view of a different classification, has been used.

‡ Cities of 30,000 and over.

The Changing Property Tax Burden

The trend of property taxes in relation to national wealth and income is shown in Table 4. The percentages for the national wealth do not represent the average rate on the real value of taxable property since, on the one hand, substantial categories of wealth are not included in the tax base and, on the other hand, the tax base includes some intangibles that are excluded from the estimate of national wealth. The national wealth is, however, a good measure of the potential tax base. It is apparent from these ratios that taxes did not decline as rapidly as wealth in the early depression years, nor have they increased as rapidly as wealth since. The ratio in 1948 was as low as it had been in 1902 and just half of that for 1932.

TABLE 4

Property Taxes as a Percentage of National Wealth and Income, 1902–1950 *

Year	Wealth	Income
1902	.8	‡
1912	.9	‡
1922	1.0	5.6
1928	1.2	6.2
1932	1.6	10.1
1936	1.2	6.1
1940	1.1	5.8
1944	.9	2.9
1948	.8	3.0
1950	†	3.3

* Estimates of wealth from National Bureau of Economic Research, *Studies in Income and Wealth* (New York: 1951), XIV. Estimates of income from *Survey of Current Business*, "income payments to individuals," and from S. Kuznets, *National Income and Its Composition, 1919–1938*, "payments to individuals excluding entrepreneurs' savings" (for 1922 and 1928). (New York: 1941)

† Estimates for wealth not available in this year.

‡ Estimates for income not available in these years.

Estimates of wealth are available only for the United States as a whole. Consequently, they cannot be used to compare trends for different regions. For this purpose individual income tax payments have been substituted. These percentages do not measure the percentage of income paid in property taxes since, insofar as these taxes are paid by business concerns, they have been deducted as a cost before estimating income payments. Except as the proportion of business taxes varies in different areas and periods, however, this offers a fair comparison of differences in the tax burden. Since variations in the national income from year

to year are much larger than variations in the national wealth, the variations in the ratio of property taxes to income are correspondingly greater than those to wealth. The trends, however, are similar.

TABLE 5

PROPERTY TAXES AS A PERCENTAGE OF INDIVIDUAL INCOME PAYMENTS FOR DIFFERENT REGIONS, 1930–1950 *

Region	1930	1935	1940	1945	1950
United States	*7.1*	*7.0*	*5.8*	*2.9*	*3.3*
New England	5.9	7.5	6.4	3.7	4.2
Middle East	6.1	7.3	6.2	3.5	3.0
Southeast	7.3	5.4	4.3	2.0	2.2
Southwest	7.1	7.1	5.5	2.3	2.5
Central	7.8	6.9	5.5	3.0	3.4
Northwest	9.7	9.8	7.9	3.6	4.4
Far West	8.3	6.2	5.2	2.3	3.7

* Grouping of states by regions follows that used in the Department of Commerce reports of income payments.

Table 5 indicates that the heaviest property tax burden is found in the Northwest and the lightest in the Southeast. The ratio for 1950 for the Southeast is just half that for the Northwest. There has been a marked decrease in the twenty years given for all regions. Only in New England is the 1950 ratio more than half of that for 1930. In the Southeast it is less than one-third. This region had a ratio above the average in 1930, whereas in 1950 it was only two-thirds of the average.

Per capita tax levies increased from \$42.24 in 1930 to \$47.05 in 1950—11 per cent. The per capita increase in the Northwest was 31 per cent, but in the Far West there was a decrease of 2 per cent.

Data for tax levies since 1950 are so incomplete that no attempt has been made to estimate them. The Department of Commerce estimate for all property tax revenues, including special property taxes, shows a 1951 figure approximately 8 per cent above that for 1950. This is a smaller increase than that for the national income in this same period. Thus it seems probable that until such time as the national income and wealth decline, general property tax levies will not increase faster than income or wealth; and there are good reasons for believing that, even with a business recession, these ratios will not return to the predepression level in the predictable future.

The first reason for assuming that the predepression level of property taxes in terms of income and wealth will not again be restored is the very great increase in federal and state assistance, both through direct grants and through the transfer to the broader state jurisdiction of former local government activities. The increase in grants is indicated in Tables 2 and 3 above. The reduction in the charges on local budgets resulting from transfer of functions is not readily measured, but local welfare and highway expenditures, for example, would certainly be very much greater if the states had not assumed direct support of a large part of this burden.

A second factor preventing any great increase in local property tax levies is the very substantial decrease in the power of the local authorities to tax property, both through increasingly stringent tax limits and through the exemption of substantial categories of property formerly included in the tax base.

Tax Limits

Both constitutional and statutory tax limits have long been in use to prevent excessive local levies. The depression, however, was responsible for a new wave of legislation introducing new limits and tightening up old ones. Most of the older limits applied to state, county, and district levies individually. Limitations on city levies were usually found in city charters and varied with individual cities or classes of cities. In the early 1930's, however, a number of states introduced over-all limits placing a total on the amount that could be levied on specific properties, regardless of the number and kind of taxing jurisdictions to which the property is subject. These over-all limits have proved far more restrictive than most of the older individual limits.

There has been little change in these tax limits in the past decade. A few more have been added, and in several states there has been some relaxation of the restrictions; but most of the recent changes have been of minor importance. Some states have classified counties according to assessed valuation, allowing the counties with the smaller assessment rolls a higher rate than those with the larger rolls, but while these changes are designed to adapt limits to local needs in some measure, the increases permitted some local authorities are counterbalanced by lower limits for others.

The effect of tax limits cannot be measured directly since tax levies are held in check by a variety of influences. However, the increase in general property tax levies in 12 states with over-all limits or comprehensive specific limits was only 16 per cent between 1930 and 1950,[2] whereas the increase in the other 36 states and the District of Columbia was 42 per cent. Also, the per capita levies in the 12 tax-limit states actually decreased a little between 1930 and 1950 (from $38 to $37) as compared with an increase in the other states from $43 to $50.

Changes in the Tax Base

The property tax base has varied greatly in different periods and among the various states. Consequently, generalizations are likely to be misleading. In the following discussion, nevertheless, an attempt is made to trace general trends, with full recognition of the limitations of such a study but in the belief that there are trends of some significance.

The early history of the property tax has been fully recorded in the tax literature, but in order to obtain some perspective on recent changes, a few of the older developments are noted here. The first property taxes in the United States took the form of levies on special types of property. In some instances rates varied with different classes of property. In other cases each class was subject to the same tax rate, but assessed valuations were determined by some arbitrary measure so that in fact certain classes of property were taxed more heavily in proportion to their value than others. These taxes resemble the classified property tax found in several states today. For the most part, however, these arbitrary measures were crude attempts to tax in accordance

[2] Alabama, Arkansas, Indiana, Kentucky, Michigan, Nevada, New Mexico, Ohio, Oklahoma, Rhode Island, Washington, and West Virginia.

with actual value rather than to favor some types of property, as does the classified property tax.

At the beginning of the nineteenth century only three states had general property taxes as the term is usually understood (i.e., a tax on all property not specifically exempted and levied at a uniform rate within any given tax jurisdiction) rather than taxes, often at different rates, on specified classes of property. Ten states, however, included in taxable property certain types of intangibles as well as tangible personalty and real estate; only Delaware, which taxed the income from property, levied no property tax at all.[3]

The shift from taxes on specified classes of property to a *general* property tax (although always with some specified exemptions) came largely between 1800 and the Civil War. At one period or another all states have employed this tax for both state and local purposes, and in most states it has been the principal source of revenue for both levels of government over considerable periods of time.

In the latter half of the nineteenth century, however, a tendency to exempt intangibles, whether by law or administrative practice, is apparent. Pennsylvania is generally credited with being the first state to accord special treatment to intangibles, with a series of laws providing for preferential rates for different classes of intangibles.[4] Connecticut followed before the end of the century with its low-rate tax on intangibles. A decline in the percentage of total assessed values represented by tangible and intangible personalty also appears in other states. In New York State, for example, personalty accounted for 25 per cent of total assessed values in the middle sixties, 20 per cent in the early seventies, and only 12 per cent in 1879.

For the United States as a whole the decline in personal property assessments was more gradual. There was a marked decline after the Civil War, from 42 per cent in 1860 to 30 per cent in 1870, but this was largely due to the freeing of the slaves. In some southern states before the Civil War taxable personalty, including slaves, had constituted more than half of the total assessment roll. After 1870 the decline was small, wavering between 20 and 25 per cent for the latter years of the nineteenth century and the early part of the twentieth century.

A second rapid decline in this ratio occurred in the decade from the middle twenties to the middle thirties. The assessed value of personalty in 1934 had fallen to less than 13 per cent of all assessed values. Since that time the proportion has increased, reaching 20 per cent in 1950. This is due partly to the fact that the proportion of the national wealth consisting of personal property has increased in recent years,[5] and partly to the fact that this was a period in which substantial exemptions were granted by the states for real estate—a movement which started somewhat later than that for the exemption of personal property.

[3] R. T. Ely, *Taxation in American States and Cities* (New York: 1888), p. 118.

[4] These followed the adoption of the Constitution of 1873 which permitted such classification.

[5] Tangible personalty is estimated to comprise 31 per cent of the national wealth in 1932 and 40 per cent in 1948. (National Bureau of Economic Research, *op. cit.*)

A comparison of the assessed value of taxable property with actual value, as estimated by the National Bureau of Economic Research, is given in Table 6. If the property tax were universal and valuations were made at 100 per cent, the assessed value figures should exceed the national wealth figures by the amount of intangible property since these intangibles, while included in the typical general property tax base, are merely claims to tangible wealth and do not appear in the national wealth estimates. In fact, however, assessed values are only a fraction of the national wealth, and they have declined from two-fifths of the actual value of wealth in 1912 to less than one-fourth in 1948.[6] The only important reversal of this trend is found in 1932, and this exception is explained by a lag in assessments. Assessments were almost as high in 1932 as in 1929 in spite of a reduction of nearly 30 per cent in the actual wealth, as estimated by the National Bureau.

[6] Note, however, a substantial increase in the ratio between 1902 and 1912.

TABLE 6

Comparison of Assessed Value of Taxable Property with National Wealth, 1902–1948 *
(Dollar figures in billions)

Year	Real Estate			Personal Property		
	Actual Value	Assessed Value	Ratio of Assessed to Actual Value	Actual Value	Assessed Value	Ratio of Assessed to Actual Value
1902	$ 70.3 †	$ 27.3	38.8	$ 21.7 †	$ 7.7	31.3
1912	112.4	54.5	48.5	44.3	14.1	31.8
1922	211.9	97.9	46.2	105.8	25.9	24.5
1928	279.7	129.0	46.1	132.8	26.1	19.7
1929	283.2	134.7	47.5	135.9	25.9	19.5
1932	210.3	131.9	62.7	88.6	21.7	24.5
1936	240.7	115.4	47.9	106.6	17.7	16.6
1939	255.6	116.5	45.6	118.5	18.5	15.8
1940	269.1	116.6	43.3	132.1	18.1	13.7
1944	327.3	124.5	38.0	171.8	24.5	14.2
1946	401.7	127.4	31.7	222.8	25.5	11.5
1948	487.4	148.9	30.5	309.6	33.7	10.9

* Data for actual value are estimates of national wealth in National Bureau of Economic Research, *Studies in Income and Wealth*, 1951, XIV, 18–19. The figure for real estate is the sum of estimates for land and structures. Personal property is the sum of equipment, inventories, net foreign assets, and monetary gold and silver. Assessed values have been compiled by the author from Census data and state financial reports. The 1902, 1912, and 1922 figures are basically those in *Wealth, Debt, and Taxation;* those for the remaining years are from state reports supplemented by the Bureau of the Census reports on *Financial Statistics of States.* The public utility property is not usually distributed between these two categories in either state or Census reports. Where no information was available as to the nature of this item, it has been arbitrarily distributed, two-thirds to real estate and one-third to personal property. The figures do not include intangibles subject to fixed low-rate taxes since this study is concerned with the base subject to variable local rates. The years listed during the past twenty-year period include all of those for which estimates of wealth are given in the National Bureau of Economic Research study. The assessed value figures are those on which the taxes for the fiscal year noted were levied.

† These figures are the average of the 1900 and 1904 Bureau of Economic Research figures. Trends in prices and production suggest that the greater part of the increase in the national wealth in these four years may have occurred by 1902, in which case the ratios should be a little lower than those given, but the difference would not be substantial.

The lag is again apparent in the 1936 figures. While the national wealth increased nearly 15 per cent in the four years 1932 to 1936, assessed values dropped approximately 20 per cent. Finally, the marked increase in assessed values in the postwar period has not kept pace with increases in actual values. Although the majority of states now provide for annual revision of assessments, few local authorities make any thoroughgoing annual revision of assessed valuations. Properties that have not changed hands and that have not been subject to substantial improvements tend to remain at the same value for years at a time. This is due partly to lack of adequate staff and partly to political expediency. Property owners do not protest failure to revise assessments downward in periods of depression as vigorously as they protest upward revisions in periods of inflation. Moreover, the majority of assessors—and probably also property owners—are convinced that the value of real estate is fairly stable and that rapid shifts in market prices, however general, should be disregarded as reflecting forced sales at one extreme and inflated values at the other rather than the "actual worth" of the property.

The tendency for assessed values to lag behind when there are marked changes in the national wealth leads to a narrowing of the gap between assessments and actual values in periods of shrinking values and a widening of the gap in inflationary periods. This lag is, therefore, partly responsible for the shrinking percentage of wealth reflected in the assessment figures in the latter part of this period. But it does not explain the difference in trends between the real estate and personal property ratios. Nor does it explain differences from state to state.

No estimates of actual wealth are available for individual states or regions, but an attempt has been made to determine whether the decline in assessments is general or limited to certain geographic areas by comparing the assessed valuations of each state for the years 1902, 1929 (the peak year), and 1950. In order to minimize the effect of different rates of population growth or decline, the assessment figures have been divided by state population; and to eliminate the effect of the changing value of the dollar, the per capita figures for 1902 and 1950 have been converted to 1929 purchasing power.

Although assessed values for the United States as a whole rose by one-third between the end of World War II and 1950, the per capita assessed valuation for the entire country was almost the same in 1950 as in 1929. This is in contrast to the period from 1902 to 1929 when per capita assessed values for the entire United States nearly tripled. When these per capita figures are converted to 1929 purchasing power, the 1929 value is still 86 per cent above that for 1902, whereas the 1950 value is 37 per cent below that for 1929. Figures for individual states are given in Table 7.

Considering individual states, the 1950 per capita assessed valuation, in terms of 1929 purchasing power, was lower than in 1929 in all but four states. In New York State alone the year-by-year assessments have more than kept pace with the growing population and inflation. The other three states with higher per capita assessments

TABLE 7

Per Capita Assessed Valuations in 1929 Purchasing Power 1902, 1929 and 1950 *

State	1902	1929	1950	Per Cent Change 1929–1950
New York	$1,244	$2,182	$2,383	+ 9
Illinois	325	1,109	1,622	+46
Montana	3,345	2,539	1,604	–37
District of Columbia	1,244	3,659	1,599	–56
Rhode Island	1,460	1,981	1,402	–29
Connecticut	1,133	1,771	1,360	–23
Nebraska	267	2,282	1,238	–46
Wyoming	668	1,991	1,219	–39
Kansas	388	1,959	1,208	–38
Nevada	939	2,724	1,182	–57
South Dakota	694	2,437	1,161	–52
Ohio	752	2,086	1,096	–47
Massachusetts	1,731	1,696	1,050	–38
Minnesota	680	2,122	1,042	–51
Wisconsin	827	1,567	1,020	–35
North Dakota	547	1,954	1,004	–49
Maryland	790	1,330	976	–27
Michigan	917	1,827	935	–49
Iowa	416	393	934	+138
Indiana	900	1,615	886	–45
Florida	290	463	884	+91
New Hampshire	796	1,337	851	–36
West Virginia	408	1,219	801	–34
California	1,317	1,296	801	–38
New Jersey	767	1,583	752	–55
Missouri	641	1,371	750	–45
Colorado	971	1,540	748	–51
Delaware	594	1,160	747	–36
Utah	646	1,402	744	–47
Kentucky	529	783	637	–19
Oregon	515	1,197	630	–47
North Carolina	282	953	629	–34
Arizona	451	1,612	627	–61
Vermont	754	766	564	–27
Texas	515	695	544	–22
Pennsylvania	909	1,119	540	–52
Maine	809	936	538	–42
Idaho	958	1,097	536	–51
Virginia	429	676	522	–23
Louisiana	356	849	478	–44
New Mexico	285	748	455	–39
Washington	660	809	444	–45
Oklahoma	123	759	429	–43
Tennessee	320	676	377	–44
Alabama	254	460	345	–25
Mississippi	244	390	265	–32
Georgia	335	452	263	–41
Arkansas	265	332	207	–38
South Carolina	231	246	153	–38
United States total	$714	$1,328	$836	–37

* Based on the Bureau of Labor Statistics index of wholesale prices.

took drastic action to increase assessment ratios at some point between 1929 and 1950. Iowa increased the legal ratio from 25 per cent to 60 per cent. Florida and Illinois, with the legal ratio at 100 per cent at the beginning of this period, revised assessment procedures to get results approaching 100 per cent.[7] It is interesting to note that the 1950 per capita assessment for New York State is by far the highest of any state, although no personal property is included. The second highest, that for Illinois, which includes intangible and tangible personalty in its assessment roll as well as real estate, is only two-thirds that of New York. There is no such discrepancy in per capita income in these two states and probably no such discrepancy in per capita wealth.

Forty-four states and the District of Columbia had lower per capita assessments, in 1929 dollars, in 1950 than in 1929. And fourteen widely scattered states—literally from Maine to California—show lower per capita values in 1950 than in 1902.

The recent inflation in real estate values is partly responsible for the comparatively low assessed valuations in 1950. The usual lag in valuations in periods of rising values has been greater than normal in the past few years because inflation in real estate values has been exceptionally rapid. The rise in values in the 1920's was moderate by comparison. This lag has more than offset the gains resulting from marked improvements in assessment techniques,

[7] The assessed valuation of Iowa for 1932 levies was more than three times that for 1931. The assessment for Florida (where by common agreement assessors had set a goal of 50 per cent) was increased between three and four times for the 1942 levies, as compared with 1941. The valuation for Illinois for 1944 was nearly double that for 1943, and this state's valuation was more than doubled between 1946 and 1947. This increase, as in the case of Florida, was the result of state action.

which have tended both to increase the ratio of assessed to full value and to do away with some of the inequalities in assessments. These improvements have been particularly marked in cities, where a large and increasing proportion of property values is found, but improvements in valuation methods in rural areas are also substantial. The use of tax and land value maps has spread rapidly during this period, stimulated by the white collar work-relief programs of the depression decade. And the use of soil survey maps for purposes of assessment in rural areas has spread as such maps have become available.

Another factor responsible for the failure of assessed valuations to keep pace with increases in the national wealth is the decline in the legal tax base. There has been a gradual disintegration of the tax until, in some states, it resembles the property taxes of the eighteenth century more closely than the general property tax of the nineteenth century. A study of legislation during this period reveals a substantial and growing list of legal exemptions. The movement to exempt personal property preceded the movement to exempt important categories of real estate. This explains the fact that the ratio of assessed to full value of personalty declined earlier than that for real estate. In some states the decline in real estate assessments can be attributed to exemptions as much as to the typical lag in revising assessments. These exemptions will be discussed in a later article.

Conclusions

Recent increases in general property tax levies have brought the total well above the 1930 peak. The average per capita levy, however, has increased very little; and in terms of 1930 purchasing power the 1950 levies are much smaller than those of 1930. A few large cities have been successful in offsetting this failure of property taxes to grow with local needs by the development of other independent taxes, but most local governments have become increasingly dependent on state and federal aid.

Tax discussions of the 1920's and early 1930's bristled with protests that the tax burden on property was excessive, and they recommended not only that taxes as a whole be reduced, but also that the proportion of revenue from other sources be increased. The reports of the National Tax Association Committee on a Plan of a Model System of State and Local Taxation recommended a triple base—property, income, and business transactions.[8] And while no commitment was made as to the suitable proportions of revenue to be obtained from these three bases, there appears to be the implication that, taking the total federal, state, and local tax system into account, no one base should bear an appreciably larger share of the total taxes than the others. At least it is made clear that each should bear a substantial proportion of the total. Other critics set as a goal for the state and local tax system a burden on real estate not to exceed 50 per cent of total tax levies.

Those who set these goals should be content with the record of the past twenty years. While the proportions of different taxes vary with business conditions as well as with the nature of the tax system, it is clear from the percent-

[8] *National Tax Association Proceedings*, "Report of the Committee on a Plan of a Model System of State and Local Taxation," 1919 and 1933.

ages given in Table 8 that the demands of the earlier critics have been more than met. Property taxes as a whole, including general and special property taxes and death taxes, declined from 51 per cent of all taxes in 1930 to 14 per cent in 1950. And taxes on real estate declined in the same period from 64 per cent of all state and local tax revenues to 34 per cent.

TABLE 8
PERCENTAGE OF TOTAL TAXES FROM PROPERTY TAXES

Year	Federal, State and Local		State and Local	
	Property	Other	Real Estate *	Other
1930	51	49	64	36
1932	59	41	65	35
1942	20	80	37	63
1950	14	86	34	66

* Estimated on the assumption that the percentage of the property tax levied on real estate is the same as the percentage of the assessment roll represented by real estate.

It is impossible to compare tax rates on full value of taxable property for these years because of the inadequacy of available data. It is possible, however, to compare rates on the potential property tax base, assuming this to be the total of national wealth. Between 1932 and 1948 the ratio of total general property tax revenues to the national wealth was cut in half; and the 1948 ratio was only two-thirds of that for the earlier period of prosperity—1928 and 1929. The earlier demands for tax relief to property owners would appear to have been granted.

Investigation of the trends in more detail reveals the fact, however, that relief has been uneven. Taxes have increased more slowly in states with stringent tax limits than in those without, and there are regional trends which do not appear to be accounted for by specific legislation. Between 1930 and 1950 per capita taxes increased nearly one-third in the Northwest and decreased slightly in the Far West. Using the ratio of taxes to income as a test, the reduction in the New England states between 1930 and 1950 was less than one-third, whereas in the Southeast it was more than two-thirds. Also, the growing list of exemptions has reduced or eliminated the tax burdens of many individuals, while their neighbors have obtained little or no reduction.

There is considerable evidence that assessment methods have improved in recent years, and inequalities in assessment appear to have been reduced, although they are still very great. However, the growing list of exemptions has made serious inroads on the tax base and concentrated the burden on property owners not benefited by tax concessions.

The average tax rate on assessed value was higher in 1950 than in 1930, but assessed values have not kept pace with wealth. The usual lag in assessments behind market values has been accentuated by the fact that the rise in real estate values has been much sharper in recent years than in the prosperous years of the late 1920's.

Continuing complaints that property taxes are unduly heavy can be attributed in some measure to force of long habit, but in some instances they are due to inequalities in assessment that still prevail. And in some instances they are due to the growing exemptions that pyramid the tax levies on an ever narrowing base.

Complaints of excessive taxes are not due to any over-all increase in the tax burden in terms of the potential base. In fact, the recent lag in assessments should provide a substantial margin in many areas for increased levies even without restoring exempt property to the tax rolls. Any such increases will, however, make further improvements in assessment performance of even greater urgency, and if the local authorities of many states are to obtain substantial further revenues from the property tax, it will be important also to reconsider policies of property tax exemption.

ISSUES RAISED BY PROPOSAL TO GRANT COST OR MARKET OPTION WITH LIFO

DOUGLAS H. ELDRIDGE *

Introduction

IN RECENT sessions of Congress income tax amendments have been proposed to permit taxpayers using Lifo (last-in-first-out) inventory procedure to have the option of valuing their inventories at the lower of cost or market prices.[1] Advocates of the change believe that it is desirable to afford relief for taxpayers who have recently adopted Lifo and to remove a possibility of tax disadvantage for those who wish to shift to Lifo procedure while prices are at historically high levels.

Professor Butters has succinctly indicated the present rule which the amendment seeks to change and some of the considerations involved as follows:

Inventory goods on Lifo must be valued on a cost basis regardless of current market values. This rule is designed to protect the Treasury against undue revenue loss and to avoid an unfair discrimination in favor of taxpayers on Lifo and against those using traditional methods. If the lower-of-cost-or-market convention could be used in conjunction with Lifo, taxpayers on Lifo would be protected from the taxation of inventory profits in times of rising prices, but nevertheless would be allowed to reduce their taxable income when market prices fell below Lifo inventory values. Should this option be granted to Lifo taxpayers, a wholesale shift to the method could be anticipated; many taxpayers have refrained from electing Lifo mainly because of their fear that the market prices of inventory goods would fall below their Lifo costs.[2]

The amending bills thus far introduced in Congress have two phases.[3] First, for Lifo taxpayers who exercise the option, they would provide an interim period in which existing cost bases

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[1] Identical bills H.R. 7447 and H.R. 7554 were introduced respectively by Congressmen Camp and Reed, 82d Cong., 2d sess. This proposed amendment has subsequently been endorsed by the Committee on Federal Taxation of the American Institute of Accountants in suggestions to the staff of the Joint Committee on Internal Revenue Taxation. See *The Wall Street Journal*, October 27, 1952, p. 7. See also U. S. Senate, *Hearings on the Revenue Act of 1951*, 82d Cong., 1st sess., pp. 960-961, 1064-1066. For a rationale favoring these earlier proposals, see H. T. McAnly, "The Need For Agreement on a Uniform Basis of Inventory Valuation," *The Controller*, August, 1951, pp. 347-351, 382ff.

[2] J. Keith Butters, assisted by Powell Niland, *Effects of Taxation on Inventory Accounting and Policies* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1949), p. 173.

[3] The wording of the bills as introduced is somewhat ambiguous. Explanatory material to accompany the bills has been prepared at the instance of Congressman Camp, and when the bills are reintroduced, it is expected that the language will be revised to achieve the objectives more precisely.

of inventories could be permanently reduced to lower market levels. The proposed interim would run from January 1, 1952 to the close of the fifth calendar year following termination of the excess profits tax. It has been expected that this period would encompass the indefinite defense emergency and five ensuing years. During this period, whenever market prices determine inventory value, the difference between cost and market is to be deductible from income, and the lower inventory valuation is to be subsequently regarded as " cost." Thus, by the end of the interim, the tax basis for a Lifo inventory of a constant physical volume would be set at the lowest market level established during the interim or at an earlier (original) cost level if that were still lower.

In the second phase, running for the indefinite future, the Lifo basis established during the interim would be treated as cost, and the inventory valued at the lower of cost or market. Declines in market values below cost would result in tax deductions for inventory losses, and recoveries of market prices up to the cost level would result in additions of inventory profits to taxable income.

Earlier proposals to grant Lifo taxpayers the option of cost or market valuation would place no limit on the time in which an inventory's cost basis could be further and permanently reduced to a lower market level.[4] These unrestricted proposals may be revived if the life of the excess profits tax does not correspond to the defense emergency or if prices should rise during the next few years. And it is not too much to expect that, if only temporary permission were granted to reduce cost bases, there would be claims later for extensions of tax treatment of this type, probably as a permanent feature of the Lifo method. For these reasons the following discussion deals with permanent as well as temporary options to reduce Lifo cost basis to lower market prices.

Even a temporary option to write down Lifo costs would be decisive in many choices of accounting procedure, and the effect of different procedures may be of large significance. With changing price levels, inventory accounting of a firm can produce such divergent results that net income may appear in some instances to be doubled, halved, or reduced to a loss, depending upon the procedure adopted.[5] The general magnitude of these effects for the national economy may be indicated by the appreciation or inventory profit which is reflected in the accounts of corporations not using Lifo and resulting from increases in price levels during recent years. In 1946 and 1947 these inventory appreciations amounted to $5.2 and $5.8 billion, and in the first quarter of 1951 they ran at an annual rate of $9.4 billion.[6] Variations in income of this size, for the firm and for the economy, will of course have important tax consequences.

The purpose of this paper is to examine broad issues raised by the proposed changes in the tax law. Inventory procedure is one of the tax salients

[4] U. S. Senate, *Hearings on the Revenue Act of 1951*, pp. 960-961, 1064-1066.

[5] Cf., American Institute of Accountants, *Changing Concepts of Business Income; Report of Study Group on Business Income* (New York: The MacMillan Co., 1952), p. 42.

[6] *Midyear Economic Report of the President*, July, 1952, p. 145.

in which present rules depart rather widely from the general concept of net income for tax purposes. This disparity has widened during the past fifteen years despite a long fought rear-guard action by the Treasury. The proposed option of cost or market for Lifo taxpayers would increase the gap. Therefore, consideration is first given, as a bench mark, to the concept of taxable income generally used in the United States. The effects in determining income of two types of inventory methods, Fifo (first-in-first-out) and Lifo (last-in-first-out), are then discussed, and the parts which they have played in the development of the tax law are outlined. Economic and equity consequences of the two methods and of the proposed amendment are indicated and analyzed under various assumptions as to price changes. The probable effects of the cost or market option upon public revenues and tax administration are then considered.

Taxable Net Income

The underlying concept of net income for tax purposes widely accepted by American theorists is that income is an increase in economic power measured in money terms.[7] In a sense, statutory and court definitions of taxable income follow this broad concept, including "gains or profits and income derived from any source whatever" and "growing out of the ownership or use of or interest in such property."[8] The tax law treats as income both earnings resulting from the ordinary course of the taxpayer's operations and also gains on property and investment which may be considered as affecting net worth directly. In practical application of the measure of income, however, it has not been feasible to compute gains or losses in taxable income until they have been realized.

It is notable that the measure of income has consistently been in terms of money units. Variations in the purchasing power of the dollar have been ignored.[9] There appears to be no generally satisfactory and accurate means of measuring taxpayers' earnings and gains in real terms.[10]

Fifo

Early tax procedures for inventories were shaped to conform to accepted accounting methods for measuring periodic net gain. Much discretion as to methods permissible under broad statutory provisions was left to the Commissioner of Internal Revenue, and in general the regulations presumed Fifo procedures. The base stock method, which yields results closely similar to

[7] Richard Goode, *The Corporation Income Tax* (New York: John Wiley & Sons, 1951), p. 168. Henry C. Simons, whose analysis and discussion of this concept has been most complete, has thus defined personal net income during a given period as the algebraic sum of the dollar value of consumption and of the change in the person's net worth. (*Personal Income Taxation* [Chicago: University of Chicago Press, 1938], p. 50.) Similarly, a business firm's periodic income may be regarded as the sum of amounts withdrawn for the use of the owners plus the change in net worth. See also *Changing Concepts of Business Income* for a recent discussion of the problems involved.

[8] Internal Revenue Code, sec. 22(a).

[9] Percentage depletion provisions constitute one exception to this general rule. These depletion deductions are calculated with respect to gross and net income derived from mineral properties, and they tend to vary directly with the price of the mineral product.

[10] Goode, *op. cit.*, Chapter 9. Equitable treatment of real as against money losses would be even more difficult.

Lifo, was expressly prohibited,[11] and this method and other procedures for valuing inventories at a nominal price or at less than their proper value are still denied by regulations.[12]

Among broad groupings of business methods of inventory valuation, the most common method has been Fifo. This assumes that inventory goods are used or sold in the order acquired. The inventory remaining at the end of a period is valued at the latest acquisition cost levels, while the charges against income for the period reflect the cost price levels prevailing when the earlier units were acquired. The effect of this procedure, with changing prices of inventory items, is to keep inventory valuations in the balance sheet roughly current (i.e., with a time lag of perhaps a few months) and to bring inventory profits and losses into account in determining periodic income.

Lifo

Lifo, as an accounting procedure, eliminates from reported current income the inventory profits and losses which under Fifo are regarded as realized and accountable for tax purposes. The latest items purchased or produced are assumed to be the first used or sold. Current inventory acquisition costs are essentially charged off against income from current sales. The value attributed to the inventory on hand at the end of a period is a residual reflecting the earlier costs of acquiring items held at the beginning and, to the extent inventory has been expanded, the costs of those first acquired during the period.[13] If a basic stock of items is on hand at all times, the value attributed to them will be unchanged over many years.[14]

It is apparent that of the two procedures Fifo conforms more closely to the concept of net income as periodic gain in economic power. While Lifo excludes inventory profit from reported income as prices rise and shows remaining inventory at the cost value of an early generation of assets, the firm

[11] T.B.R. 65 Cumulative Bulletin 1, rule No. 531 (1919).

[12] *Regulations* 111, sec. 29.22(c)-2.

[13] This is not necessarily so for tax purposes since increments of Lifo inventories are permitted to be built up under various procedures, e.g., Lifo, Fifo, or average cost. *Regulations* 111, sec. 29.22(d)-2(4).

[14] Many technical and controversial aspects of Lifo in determining business income cannot be discussed within the compass of this paper, but it may be noted that among various accounting conventions Lifo procedure represents a comparatively wide departure from traditional views on associating costs with business processes. "The amount charged against revenue under LIFO may be the cost (or even the quoted price) of goods (such as raw materials purchased at a foreign port and still there) which could not possibly have been used in production, but which replace, not necessarily with identical goods, materials that have been used. It may not be the cost of any goods actually purchased, but may be determined by a price index. The amount carried forward as inventory may not be the cost of anything that is, or might conceivably be deemed to be, on hand, but the cost of something that has been many times replaced." (*Changing Concepts of Business Income*, p. 44.)

Comments by Stephen Gilman (*ibid*., p. 120) may also suffice to indicate the concern of some authorities with Lifo effects "conceivably, below the limits of reasonable conservatism," upon the balance sheet. "This effect contradicts our [Study Group of American Institute of Accountants] general thesis relating to decreased purchasing power of the dollar. It is inconsistent in that it provides 'inflated' costs in the income statement and correspondingly 'deflated' asset values in the balance sheet—a paradox which should cause concern to the certified public accountant who is requested to give as his opinion that the client's balance sheet presents fairly the client's financial position." See also, Henry C. Simons, *Federal Tax Reform* (Chicago: University of Chicago Press, 1950), p. 103.

nonetheless has in its control assets currently worth more than this Lifo value. Even though the appreciation results from a general rise in prices, the firm is in a preferred and stronger economic position as compared with others who do not hold inventory assets, who may have their assets in the form of cash or bonds, or who rely on the sale of personal services for income. An inventory profit may also result from a rise in relative prices. A firm holding an inventory, the value of which has risen while prices of other goods have declined, has enjoyed a gain in real as well as in money terms. These gains from either general or relative price increases may be of immediate importance to the firm. With rising prices the current enhanced value of inventory will be considered in realistic calculations of working capital, current ratios, and net worth.

Lifo for Tax Purposes

The belief of tax administrators that Lifo procedure did not properly reflect taxable income provides at least a partial explanation for their earlier reluctance to endorse this method.[15] In the middle 1930's, however, spokesmen from nonferrous metal and leather industries which maintained large inventory stocks requested Lifo on the grounds that, with rising prices, the Commissioner's requirement of Fifo procedure resulted in the taxation of large "paper profits" or fictitious gains.[16] While Lifo had not been permitted taxwise, it was pointed out that firms in these industries used that method for their own accounts. The Treasury and both congressional taxing committees, after hearings in 1936 and 1938, rejected the request. However, a Senate floor amendment to the 1938 revenue bill permitted Lifo for industries in which it was commonly used, and the amendment was accepted by the Conference Committee after restriction to the leather and nonferrous metal industries.

In the following year the statutory provision was broadened to permit any firm using Lifo for business purposes to use it also in determining income tax. This so-called elective inventory method did not depend upon the character of the business nor on maintaining identity of commingled inventory items. Once the election was made, it was not to be revoked without permission of the Commissioner. And the inventory henceforth was to be taken at cost, not cost or market.

Those taxpayers who elected Lifo at that time enjoyed large tax benefits since there were substantial price rises in ensuing years. The few companies which had used this inventory procedure prior to 1938 were joined during the 1940's by many others, but there was not a mass shift among taxpayers from Fifo to Lifo. Professor Butters has shown that Lifo users are concentrated mainly among large companies in manufacturing and department and specialty stores. He estimated that at the end of 1947 some 13 to 17 per cent of total manufacturers' inventories (stated in 1947 prices) were on Lifo.[17] In 1951 the Department of Commerce

[15] Cf., Butters, *op. cit.*, p. 178.

[16] See, for example, statements in U. S. Senate, *Hearings on the Revenue Act of 1938*, 75th Cong., 3d sess., pp. 143-167, 429 ff.

[17] Butters, *op. cit.*, pp. 42-63.

estimated that the "value of Lifo inventories currently represents roughly one-tenth of the total book value of nonfarm inventories." [18] Thus only a small fraction of all businesses have availed themselves of the tax benefits of Lifo.

Among the several reasons for not shifting to Lifo have been concern about the accounting and management burdens involved,[19] the feeling that inventory profits and losses are comparatively unimportant in some industries, and reluctance to have current profit showings reduced.[20] But there is also no doubt that the form of the tax rules and their interpretation have been restraining influences. The denial of inventory loss deductions when market prices fall below cost has meant that future price changes and tax rates must be carefully considered, for the benefits conferred by Lifo during a price rise might possibly be outweighed by the effects of a subsequent price decline.

The appeal of the Lifo method, and also its feasibility for many firms, depended upon the type of supplementary regulations developed for its administration. The important tax and business advantages of Lifo are derived only if the inventory is rarely if ever liquidated. A broad classification of inventory would enable use of the method for firms which maintained a fairly stable over-all inventory, even though component parts of the group were built up and depleted from time to time. But if only narrow groups of homogeneous items were permitted Lifo treatment, few industries would find it advantageous.

In the early 1940's prevailing opinion in the accounting profession appeared to hold that Lifo was suitable only for firms maintaining homogeneous inventories such as stocks of hides or metals. There was much uncertainty among taxpayers as to whether Lifo was suitable for their business and whether administrative rulings would require narrow inventory categories which would vitiate its use. In 1944 many of the uncertainties were resolved by a liberal administrative ruling.[21] This permitted broadly similar raw materials to be grouped in one inventory classification, including the raw material content of goods in process and of finished goods.

Modification of rules for complex inventories of department stores came more slowly. In 1941 this industry developed the idea of offsetting changes in the value of a given volume of physical items through the use of an index of nationwide department store prices.

[18] *1951 National Income Supplement to the Survey of Current Business*, p. 124.

[19] Goode states that "especially in the retail field, the complexity of Lifo has effectively barred its use to all but the largest firms." (*Op. cit.*, p. 171.) M. P. McNair and A. C. Hersum have assessed these difficulties as follows: "Admittedly the calculation of a Lifo cost inventory for a department presents greater difficulties than would the ascertainment of a Fifo cost value by means of the coded costs found on the merchandise in stock at inventory time. Quite clearly also Lifo reckoning is a distinctly more complex business than the familiar Fifo retail method; and Lifo furthermore does not replace the retail method but is superimposed on it. . . . Procedurally Lifo is not simple. But certainly it is not so intricate or recondite as to tax unduly the capacities of the average controller's organization in a department store." (*The Retail Inventory Method and Lifo* [New York: McGraw-Hill Book Co., Inc., 1952], pp. 230 ff.)

[20] Butters, *op. cit.*, p. 98.

[21] T.D. 5407, Cumulative Bulletin, 1944, p. 83.

The aggregate inventory valuation for whole departments of varied goods could then be adjusted to exclude the estimated effects of price fluctuations. A number of department stores adopted this method of applying the Lifo principle, but the Treasury refused to accept it for tax purposes. Many department stores then dropped the method, but others contested the ruling in a test case.[22] The Tax Court in 1947 upheld the taxpayer's use of Lifo, retroactive to 1941. As a result Treasury policy was changed, and regulations were issued permitting use of special Bureau of Labor Statistics indexes in applying Lifo methods to department store inventories.

Cost or Market for Tax Purposes

In the early days of the income tax, the lower of cost or market convention for valuing inventories in conjunction with Fifo procedures was permitted by administrative ruling.[23] The convention, as a practical rule of thumb, had been generally accepted for business purposes. Since the extent of recoverability of inventory costs in future periods can only be guessed, these earlier costs are compared with current market prices and the lower figure taken for the final inventory of a period and for subsequent reckoning. Any excess of cost over market is charged off against current income.

The strict propriety of this convention might be questioned since it uses transitory market prices to provide for losses which have not been, or may never be, sustained. In income tax procedure it is an anomaly "as a concession by the Treasury from a strict realization criterion. In its asymmetry it is obviously biased against the Treasury, since it permits deductions of unrealized losses while not permitting or requiring the corresponding recognition of accrued gains."[24] These features, however, seem comparatively unimportant. The convention serves traditionally conservative objectives of keeping inventory figures in the balance sheet current during price declines. And its effect on income is essentially one of short run variations in timing.

The proposed extension of the cost or market convention to Lifo procedures is open to more serious objection; in fact their combination appears incongruous. Lifo advocates have been willing to subordinate meaningful balance sheet valuations to obtain what they regard as a better measure of income, i.e., generally one achieved by stating revenues and costs more nearly in terms of the same price level. Nonetheless, many accountants hold that the use of Lifo for business purposes does not warrant showing inventory at a figure above market valuation.[25] When prices decline and Lifo inventory costs exceed market, it is recommended that the cost figures should be written down to market, even though this writedown violates the above criterion for measuring income.

The effect of combining the cost or market convention with Lifo is quite

[22] *Hutzler Brothers Co.* v. *Commissioner*, 8 T.C. 14 (1947).

[23] T.D. 2609 (Treasury Decisions, Vol. 19, p. 401 [1917]).

[24] Simons, *Federal Tax Reform*, p. 103.

[25] "Inventories—A Tentative Statement by the Research Department of the American Institute of Accountants," *Journal of Accountancy*, LXX (1940), 329.

different from combining it with Fifo. The latter combination may distort the timing of income from period to period as compared with a simple Fifo procedure, but over a series of periods these differences tend to be evened out. With the convention and Fifo, a price decline below costs at the end of a period will result in a reported inventory loss—a reported loss which anticipates a loss actually to be realized in a subsequent period if prices remain down, or a reported loss which will be offset by higher reported profits if prices rebound. With a continuing use of the convention and Lifo, a dip in inventory prices results in reported losses without reporting of subsequent compensating profits. Moreover, a firm with a heterogeneous inventory may report inventory losses even though the aggregate value of its inventory has remained constant or appreciated. Among groupings of inventory items there are commonly diverse price movements. With a dispersion of market prices the lower of cost or market convention recognizes losses for groups in which prices have declined, but Lifo ignores inventory profits where prices have risen. If various inventory groups have different price cycles, losses might be reported in a number of accounting periods although the average market value for the entire inventory does not decline.

Perhaps the downward-only revision of inventory values may ultimately be offset upon complete inventory liquidation. But meanwhile, and perhaps while ownership of a corporation passes through several generations of shareholders, reported income is less than would be indicated by either Fifo or straight Lifo methods.

These results seem quite incompatible with basic tax rules for determining current income and with the essential logic of the Lifo principle of income determination. The fact that in recent proposals only a limited period would be provided for permanent downward adjustment of Lifo costs suggests that even proponents of combining cost or market with Lifo have misgivings as to the propriety of the method.

Long-Term Price Trends and Tax Equity

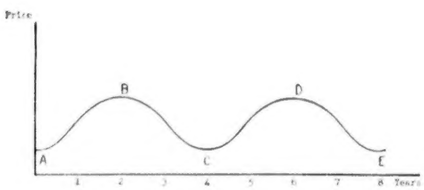
The case for combining cost or market with Lifo is largely one for redressing alleged inequities. Under the tax rules as now developed, it is clear that different groups of taxpayers will not be treated in an even-handed fashion. Assume for the moment that price levels have a persistent upward trend. Then Lifo users will be consistently undertaxed as compared with Fifo users or with taxpayers for whom inventories are not significant. But if prices take a downward trend, the tables are reversed, and Lifo users will be relatively overtaxed. In a relative sense it might be argued that over a long-term price decline the refusal to recognize inventory losses, which are deductible by other taxpayers, may impair the capacity of a Lifo user to conduct business and meet competition, just as it is argued that taxation of the inventory profits of a Fifo user on a price rise impairs its financial position as a going concern.

The insistence that Lifo inventories be carried at cost instead of market does not provide tax equity if the long-term price trend is either up or down. In this setting its justification seems to be

that if Lifo users should seek to gain a tax advantage on an expected upward trend, they should be penalized if their expectations are wrong and the trend is actually downward. The unhappy tax situation of the Fifo user who finds prices trending upward is somewhat mitigated by the fact that when he wishes he can elect to adopt Lifo.

Cyclical Fluctuations and Tax Equity

But prices commonly fluctuate rather than follow a linear trend. To illustrate effects of inventory procedure, it may be assumed simply that the prices of an industry's inventory items follow a sine curve, say a four-year cycle of constant amplitude from trough to crest.[26] For simplification it may also



be assumed that a proportional tax is imposed at stable rates and that income from current operations is adequate to absorb any inventory losses. A taxpayer who adopted Lifo at A, the bottom of the cycle, would maintain this valuation throughout. This taxpayer would exclude appreciation in inventory values from income as prices rose from A to B, and he would likewise exclude inventory losses from income calculation as prices fell from B to C. A Fifo user would report and pay tax on inventory profits from A to B, but these would be fully offset by inventory losses from B to C, and hence taxes would be commensurately reduced in the latter period. Over a full cycle the taxes of the Lifo and Fifo users would be the same in aggregate though different in timing.

If under these circumstances it seemed prudent for a Fifo firm to shift to Lifo, the election could be made without disadvantage at the bottom of any cycle, say C. But if the election is made at any other point in the cycle, a permanent tax loss is sustained. At B, for example, the firm would have paid taxes on inventory profits from A to B. Adoption of Lifo at that time would mean, under present rules, the carrying of inventory values thereafter at the B level. While subsequent inventory losses and gains would be ignored for tax purposes, there is no way to recoup the taxes paid on prior inventory profits.

A change of the tax rules to permit valuation of Lifo inventories at the lower of cost or market would, under these cyclical conditions, not be of advantage to taxpayers who maintained a stable physical volume of inventory and who adopted Lifo at the bottom of a cycle, A or C. It would help taxpayers who shifted to Lifo at any time when prices were higher. These taxpayers could then reduce Lifo values to the low points of the cycle, placing themselves on a par with those who had been prudent or lucky enough to adopt

[26] Further consideration might also be given assumptions of price fluctuations around rising and falling trends. Particular effects on Lifo and Fifo users would vary according to assumed rates of rise or fall and amplitudes of fluctuation. However, the nature of these effects is suggested by the simpler discussion of secular trends and fluctuations around an even price level.

Lifo at these points.[27] There would be the one-time write-off of inventory losses to the lowest market value, resulting in savings to the taxpayer and revenue loss to the Treasury.

If the amplitude of the cycle widened, a continuing write-down option would permit all Lifo users to establish new low points for inventory values. They would share with Fifo users the privilege of charging off against income the inventory loss indicated by market values of the lowest price period. This would widen the price range over which subsequent inventory profits and losses of Lifo users would be excluded from tax calculations. Once the new low inventory basis were established, however, the write-down option would not be of further aggregate benefit to Lifo taxpayers. Over subsequent cycles of this wider amplitude all Lifo taxpayers would be treated similarly, and they would pay the same aggregate (though differently timed) taxes as Fifo users whose circumstances were the same except for inventory procedure.

A dip in prices to an unusually low level and corresponding reduction of Lifo cost bases would give a lasting tax benefit to Lifo as compared with Fifo users. To the extent that prices subsequently rose and stayed above the low point, Fifo users alone would be taxed upon inventory profits with no compensating loss offset.

If only an interim period is provided for the writedown of Lifo bases, the tax relief available will naturally depend upon the course of market prices within the period. The assumption underlying this proposal is that prospectively normal low points will be reached in the interim, and these (or lower cost bases already established) will serve satisfactorily as Lifo "cost" for the future. If the bottoms of cycles or unusual price dips occur during the interim, the tax relief available for high-cost Lifo inventories would be the same as described above. Conceivably, on the other hand, prices might follow a rising trend during these few years, and the temporary option would afford no advantage. Most likely, with varying changes in relative prices, different degrees of tax relief would be afforded, ranging from taxpayers whose inventories reach rock-bottom price levels to those whose prices do not decline. Following the interim period all Lifo taxpayers would ignore inventory profits and losses when prices were above their respective "cost" bases, and they would reckon both losses and gains for market price changes below those bases. On the simplifying assumptions made above, Lifo users would pay the same aggregate taxes over subsequent cycles as Fifo users. If market prices declined secularly below their Lifo bases, they would be treated like Fifo taxpayers, and if prices rose secularly, they would pay no taxes on inventory gains.

These possibilities of immediate tax relief and a secure position for the future would give Lifo strong appeal over Fifo. The appeal would be enhanced by the fact that in reality tax rates are not a fixed proportion of income even for corporations, and tax rates are not stable. If countercyclical fiscal policy is pursued, it is likely that

[27] This advantage would be shared by new firms which began business with Lifo procedure when prices were high and which had no previous inventory profits subject to tax. Other Lifo firms would benefit to the extent inventories had been expanded when prices were high.

tax rates will be raised in inflationary periods and reduced in periods of serious price declines. Moreover, even with present provisions for loss carryover, net income may not be available to absorb large inventory losses. In consequence, the tax reductions effected on price declines by Fifo users may be negligible and inadequate to balance out heavier taxes paid on inventory profits on price rises.

Equity among Lifo Users

From the standpoint of equity for taxpayers who have lately adopted or wish to adopt Lifo, a somewhat plausible case can be made for permitting valuation at the lower of cost or market. This change would not likely enhance the comparative advantage enjoyed by those who early shifted to Lifo, say in 1938-1941. It seems unlikely that prices of many inventories will drop below the levels prevailing when the early elections of Lifo were made. The long-term prospect appears to be for higher rather than lower prices for most inventory items.[28] But taxpayers who adopted Lifo after World War II or wish to do so now are at a disadvantage relative to the early electors. They will have been taxed on inventory appreciations up to the time they elect to change to Lifo and, under present rules, are foreclosed from subsequent inventory loss deductions. If prices decline somewhat from the levels at which Lifo was elected, they will at that point have been overtaxed as compared both to earlier Lifo users and taxpayers remaining on Fifo. If prices thereafter rise above the level at which Lifo was elected, they will be at an advantage as compared to Fifo taxpayers but still at a disadvantage relative to the earlier electors of Lifo.

The problem of equitable treatment of taxpayers who may wish to adopt Lifo has been complicated by the gradual shift in official policy regarding this method. Among retail merchants there were some who elected Lifo in 1941, contested the Treasury's adverse ruling, and in 1947 were assured the use of Lifo, retroactive to 1941. Other taxpayers in various industries abandoned their Lifo election or refrained from the election because of early Treasury disapproval. This situation has evoked perennial pleas for retroactive election of Lifo. It seems undesirable tax policy to accord retroactive tax benefits only to those who contested Treasury rulings, thus putting a premium on contentiousness, while refusing like treatment to those with similar claims but who acquiesced with Treasury interpretation. Serious problems stand in the way of rectifying these inequities, however. A general option for retroactive application of Lifo would mean substantial loss of revenue and large tax savings to taxpayers

[28] Among the factors which support an assumption of a rising price trend are the following: the threat of war and cold war; adherence to a national objective of full employment; the tendency to utilize countercyclical policies more readily to meet deflation with deficits than to meet inflation with tax surpluses; strong labor unions; and demands on government for social services. For an appraisal of these and other factors see "Agenda for the Age of Inflation — I," *The Economist*, August 18, 1952, pp. 382-384. See also the statement of Seymour Harris, "that it is a conservative estimate to assume in view of all the institutional factors making for inflation that we would have an increase of prices of only 50 percent in the next 25 years, which matches our 1925 to 1950 record." U. S. Congress, Subcommittee on General Credit Control and Debt Management, *Hearings on Monetary Policy and Management of the Public Debt*, 82d Cong., 2d sess., p. 357.

who now have the advantage of hindsight but who had no intention of electing Lifo in 1941. On the other hand, measures short of a general option must draw arbitrary dividing lines with attendant inequities.[29]

Because of the difficulties involved, Congress has repeatedly rejected proposals for retroactive application of Lifo. Some relief might be afforded in this area by the proposal to value Lifo inventories at the lower of cost or market. Taxpayers who elected Lifo following World War II, or who wish to do so now, could then write down inventory values on price declines, more or less narrowing the comparative advantage enjoyed by those who establish much lower, 1938-1941, Lifo bases.

From another standpoint, however, some taxpayers may question whether granting an opportunity to reduce this comparative advantage increases tax equity. Those who have elected Lifo under existing tax rules have been willing to run the risk of price declines. The election of Lifo is now available on similar terms to all who believe that it will be advantageous prospectively. The proposed amendments would change the terms for election and eliminate the risk for latecomers.[30]

Equity among Taxpayers in General

The present rather restrictive policy toward Lifo, which requires a cost valuation, tends to limit the area in which different rules for the determination of taxable income apply. A change in the method of Lifo valuations, inducing more comprehensive use of Lifo, might accord more even-handed tax treatment among Lifo users, but it would be at the expense of aggravating discrimination against taxpayers who remain on Fifo or who do not carry inventories as a source of income. The tax liabilities of income recipients generally are not insulated from the effects of price changes. If Lifo were to be used more extensively in times of rising prices, tax rates would have to be raised (or rate reductions foregone) to maintain desired revenue yields, thereby increasing the comparative disadvantage of other taxpayers.

Broad uniformity and equity of the income taxes are undermined if different standards for measuring the tax base are used for different income sources. Such inconsistencies are most acute with progressive individual income taxes and a hierarchy of corporate rates, i.e., small corporation, regular normal and surtax, and excess profits tax. It is futile to attempt to levy taxes equitably according to the size of total income or gain and at the same time to differentiate as to what is net income according to source. Thus a policy tending to deter use of Lifo may be regarded as a means of checking larger inequities within the tax system.

There is, of course, the awful alternative of attempting through index numbers to provide an escalator clause in computations of other deductions, exemptions, and measures of income. This would compound the complexities of the tax law and administration. Also pertinent here are considerations mentioned by a recent congressional subcommittee in connection with purchasing power bonds:

[29] Butters, *op. cit.*, p. 220.

[30] From this standpoint the position of the Lifo elector under the proposed change of rules would be analogous to an investor who wishes to buy the common stock of a growth company for long-term appreciation, but who may also enjoy the option of reducing his purchase price to any lower level that the market price may reach in the future.

More important, it would undermine public confidence in the future purchasing power of the dollar by giving the impression that Congress had transferred its attention from preserving this purchasing power to protecting particular classes in the community from a decline which it considers inevitable. . . . Contracts expressed in fixed numbers of dollars constitute a necessary and desirable part of the foundation for our social and economic system, and . . . efforts of the Government must be devoted to preserving the integrity of this foundation rather than endeavoring to provide a substitute.[31]

Economic Effects of Lifo

If Lifo for tax as well as business purposes clearly operated toward economic stability, an argument on these grounds could be made for tax amendments which would induce more widespread use of Lifo. The tax consequences, however, appear to be away from rather than toward this desirable goal.

The full economic effects of Lifo throughout fluctuations in business activity have not been clearly established, though it does act toward stabilizing business income *before taxes*. Fifo tends to accentuate swings in business income; inventory profits are added to reported income on upswings and inventory losses deducted on downswings. When prices are rising, larger showings of profits may contribute to a boom, fostering undue optimism and inducing management to undertake expansion programs, pay increased dividends, and yield more readily to demands for wage increases out of swelling profits. Price declines conversely may result in excessive pessimism and contractions. Lifo, by excluding inventory profits and losses from reported income, may avoid these tendencies. But these results of the two inventory methods may be more or less offset by the effects of income taxes. As compared to Lifo, Fifo will mean higher taxes on upswings and lower on recessions. The relative tightening and easing of disposable income positions may be enough to counterbalance the effects of pretax income on business psychology.

Professor Butters, after weighing these conflicting tendencies, concluded tentatively "that, so far as economic effects are concerned, it would be wise to adopt a concept of income which excludes the distorting effects of inventory profits and losses."[32] This view has also been expressed by Professor Harold M. Groves in a tax study for the Committee on Economic Development. He feels that the trend toward Lifo has been a hopeful one and should be furthered.[33] In contrast, Richard Goode in his outstanding study of the corporation income tax concludes that experience with Lifo has been inadequate to reach a balanced judgment on its desirability. He emphasized that the effect of Lifo in reducing taxes during inflationary periods and of increasing them during recessions may be disadvantageous to taxpayers over a full business cycle. Moreover, he regards this effect as clearly contrary to generally accepted ideas regarding desirable countercyclical fiscal policy.[34]

[31] *Monetary Policy and the Management of the Public Debt*, Report of the Subcommittee on General Credit Control and Debt Management, 82d Cong., 2d sess., p. 39.

[32] Butters, *op. cit.*, p. 11.

[33] Groves, *Postwar Taxation and Economic Progress* (New York: McGraw-Hill Book Co., 1946), p. 153.

[34] Goode, *op. cit.*, p. 171.

Amendments which would be conducive to use of Lifo for virtually all inventories instead of for comparatively few would weaken the automatic stabilizing tendencies of income taxes as well as the effects of countercyclical rate changes. A much larger volume of inventory profits would be immune from taxation. Such a change in the tax system does not appear essential to correct the psychological effects of pretax inventory profits or losses. Sound management need not regard taxable income as the amount relevant for dividend, wage, and expansion policies. As the significance of inventory profits and losses for these latter policies is increasingly appreciated, management may be encouraged to deal with them by means of special reserves or Lifo for their own business purposes, even though these practices would not serve to reduce their tax liabilities.[35]

Revenue Considerations

The effects on public revenues of the proposed change for Lifo inventory valuations cannot be assessed with much precision. Undoubtedly the short-term revenue losses would be substantially less than would be occasioned by granting a general option for retroactive adoption of Lifo. The initial losses resulting from downward revision of Lifo costs would occur on price declines when countercyclical policy would call for easing of tax burdens. And the tax savings accorded particular firms would vary with the height of prices prevailing when Lifo was elected or Lifo inventories expanded. Some of the revenue loss that might be expected from the proposed amendments may also be incurred under present rules if Lifo has long-term appeal to many firms now using Fifo. Taxpayers who wish to shift to Lifo may effect inventory loss deductions and establish comparatively low Lifo valuations by timing their elections to coincide with price recessions.

The present rather restrictive policy toward Lifo, however, protects the public revenues. Over the long term, the more substantial revenue effects of the proposed change would likely result from the greatly increased use of Lifo and price rises. A much greater volume of inventory profits would quickly be excluded from tax. The present requirement of cost valuation does not prohibit a shift to Lifo but operates as a deterrent. A hazard is imposed because price trends are not certain and because there is perhaps greater uncertainty as to near term price changes which makes the comparative advantage of immediate election questionable. With this requirement only a small fraction of all business concerns have elected Lifo during a decade in which there have been some price fluctuations but an over-all upward trend.

Administration and Compliance

Without the requirement of Lifo cost valuation, it appears that virtually all firms for which inventories are significant would be rapidly induced to adopt Lifo, even though that method were not particularly suitable for general business purposes. This would necessitate widespread modification of accounting systems and tax procedures.[36]

[35] McNair and Hersum, *op. cit.*, p. 337.

[36] It has been facetiously suggested that the proposed amendment to permit lower of cost or market with Lifo be subtitled "The Tax Accountants' Full Employment Act."

Unless the age of emergencies is past, the more general use of Lifo would greatly accentuate such administrative and compliance problems as have arisen twice in recent years because of the involuntary liquidation of Lifo inventories. In both World War II and the present defense emergency shortages of supplies have prevented replenishment of some Lifo inventories. The liquidation, partial or whole, of inventories carried at earlier low-cost valuations has the effect of realizing substantial inventory profits in periods when they are subject to high rates of ordinary income taxes and perhaps also excess profits tax. Lifo taxpayers have requested and received tax relief for involuntary liquidation due to war or defense conditions, providing they rebuilt the inventories within a specified subsequent period. The inventory profits realized during emergency period liquidation have been permitted to be reduced by the excess of the cost of replacing these inventories following the emergency over the original inventory cost valuation.[37] Taxes paid on inventory liquidation are refundable when these profits are subsequently deemed to be offset by the excess of replacement costs. And the replenished inventory is valued at the Lifo cost prior to liquidation. Besides the burden of making refunds, with almost inevitable delays, this procedure necessitates keeping the taxpayer's returns open for the several years affected and slows completion of auditing.

Widening the use of Lifo will also aggravate difficulties of tax enforcement in other ways. Lifo procedure permits management greater flexibility in reporting the amount of taxable income reported in a given year. "Some accountants unsympathetic to Lifo cite the possibility of 'juggling' income in this manner as an important argument against its acceptability as an accounting method."[38] In part this flexibility lies in the privileges of carrying the inventory at an earlier cost figure, of building up inventories on a Lifo, Fifo, or average cost basis, and of liquidating them on a Lifo basis. Additional leeway is available through the grouping and regrouping or pooling of inventory classes. Tax administrators are confronted with the problem of whether these practices are for bona fide business purposes or largely to minimize taxable income. An option to value Lifo inventories at cost or market would work toward greater flexibility in the reporting of income and increase the administrative burden.

Summary and Conclusion

With a rising trend of prices, the option of cost or market valuation with Lifo apparently would not provide additional tax advantages with respect to inventories for which Lifo was elected in the years when it was first available for tax purposes. The option would mainly remove the possibility of comparatively heavier taxation on dips in price levels for those who adopted Lifo following World War II or who wish to adept it now. To the extent early Lifo electors have recently expanded inventories, they also would be in the position of those who had elected Lifo in the later years.

While the option would tend to equalize treatment among existing and

[37] Internal Revenue Code, sec. 22(d)(6).

[38] Butters, *op. cit.*, p. 175. Cf., "The Possibilities of Manipulation," McNair and Hersum, *op. cit.*, pp. 269-278.

would-be Lifo taxpayers, it would, by fostering wider use of Lifo, tend to aggravate discrimination against taxpayers for whom Lifo is not feasible or who do not have inventories as a source of income. The option would widen the gap between inventory procedures and the general rules for determining taxable current income. It would mean substantial long-run losses of revenue to the Treasury, would operate contrarily to countercyclical fiscal policy, and would intensify difficulties of tax administration and compliance. The use of lower of cost or market values is not essential to Lifo procedure, but on the contrary it seems incongruous with basic principles of that method. On balance, the proposed amendment for the benefit of some Lifo taxpayers appears to be an undesirable change in the tax law.

Realistically the probable policy alternatives are simply between accepting or rejecting the proposed amendment, with the political odds favoring the granting of this special type of tax relief despite its objectionable features. However, either maintenance of the present rule of only cost valuation with Lifo or a change that would permit all inventory-using taxpayers to adopt Lifo on more nearly equal terms leaves much to be desired. Either course means significant inequities and economic biases in the tax system.

Perhaps it is academic to suggest that inventory procedures deserve thoroughgoing and consistent reformulation. The development of the tax law stems more from experience than logic. Once a provision affording special advantage is adopted to meet particular situations, such as for inventories of hides or metals, there are strong pressures for its scope to be widened. Other taxpayers in somewhat different situations have cogent claims for similar treatment. Retracing policy steps once taken is difficult, for those who have availed themselves of a provision assume a vested interest. Nevertheless, aberrations in the tax system, which may conveniently be disregarded or countered by temporizing measures when tax burdens are light, will with continuing high revenue needs lead to accentuated differential tax treatment. In consequence it may not be too much to hope that basic realigment of rules toward consistency will be undertaken.

If it is desirable to place all taxpayers with inventories more nearly on a common footing, this could be done by eliminating sec. 22(d) of the Internal Revenue Code, which permits the use of Lifo. It would be a much less drastic change in accounting and tax procedures for the small fraction of taxpayers now using Lifo to revert to various appropriate Fifo procedures indicated by sec. 22(c) than to create strong tax inducements for the great bulk of inventory taxpayers to shift from Fifo to Lifo. Taxpayers now on Lifo might be given the advantage of capital gains rates on the inventory profits that would be realized upon a reversion to Fifo order of accounting. This privilege would facilitate adjustment without undue hardship.

Reversion to Fifo procedures would move in the direction of broad uniformity and relative simplicity in the operation of the tax law. Simple and uniform rules obviously will not be perfectly suited to the multifarious special circumstances of different taxpayers.

There is always pressure for specific tax relief for groups who feel their situation is exceptional, even though special treatment intensifies tax complexities and sacrifices revenue. If it is feasible to forego revenue for such purposes, it would seem preferable that this leeway be used for general rate reductions, which would make more uniform tax rules tolerable.

The realignment of inventory procedures more nearly in accord with basic principles of taxing monetary income would check a subverting drift in tax proposals.[39] If, on the contrary, virtually all income from inventories is to be immunized from the effects of price changes, it will be increasingly difficult to resist similar proposals for income derived from depreciable assets, capital gains, pensions, annuities, and so on. By the time all potential claimants for such treatment are provided with escalator devices for computing tax liabilities, the income tax will have lost much of its revenue yield and its effectiveness as a fiscal means of arresting inflation.

[39] For example, the Study Group of the American Institute of Accountants observes: "It is difficult to see how acceptance of LIFO as now applied can long be combined with rejection of the current price level as a basis of changes for property exhaustion." *Changing Concepts of Business Income*, p. 60.

E. Cary Brown in a recent study, *Effects of Taxation on Depreciation Adjustments for Price Changes* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1952), strongly favors maintenance of the present concept of taxable income. He concludes on grounds of equity, economic stability and administrative problems of measurement "that historic cost depreciation is more desirable than replacement-cost depreciation for tax determination." (p. 17.) Moreover, he emphasizes the similarity of the latter with Lifo. "They both exempt from taxable income increments in money values that are attributed to price changes. Judged solely from the standpoint of equity, inventory owners under these conditions are favored under present law relative to all other taxpayers. If depreciable-asset owners are placed on a par with them, inequities are reduced in one sense and increased in another. To achieve equality of treatment it would be necessary to go back to Fifo; or move over to the difficult concept of real income. . . ." (p. 73.)

CARRYOVER OF BUSINESS LOSSES

MORRIS BECK *

I. PRELIMINARY CONSIDERATIONS

IN 1950 Congress replaced the two-year carryback and two-year carryforward of net operating losses, in effect since 1942, with a one-year carryback and five-year carryforward.[1] To the taxpayer this change meant that eligible losses, starting with those of 1950, could be spread over a period of seven, rather than five, years. Of greater significance was the increased emphasis placed on the carryforward as compared with the carryback. The change in emphasis has serious implications for such problems as the stabilization of business spending and the promotion of new enterprises. Some of the more obvious economic effects will be pointed out later on, but the main object of this paper is to present the results of a quantitative study of loss carryover.[2]

Losses and Tax Equity

Interperiod offsetting of losses is primarily an instrument for promoting equity in income taxation. In the absence of carryover provisions, a firm with alternating losses and profits pays a larger aggregate amount of income tax over a period of years than does a consistently profitable firm earning the same (algebraic) net income for the period.

Compare Firm A, which earns $500 in each of two successive years, with Firm B, which loses $1,000 one year and makes $2,000 the next. The two firms realize the same net income over the 24-month period; yet Firm B will be liable for tax on twice as much income as will its consistently profitable rival unless the tax law permits B to carry its loss forward to the succeeding year.

The principle of allowing the loss of one year to offset the profits of other years has been recognized by federal tax statutes since 1918, with an intermission from 1932 to 1939. Other countries, too, have incorporated the loss carryover feature in their tax laws. At the present time Canada and Great Britain have the same offset allowance as we do, namely, a one-year carryback and five-year carryforward. The Netherlands permits losses to be carried forward for two years; Japan and Germany, three years; Argentina, four

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[1] Revenue Act of 1950, sec. 215.

[2] As here used the term "carryover" means either carryback or carryforward. The reader is warned that in the literature of this subject carryover and carryforward are used interchangeably to designate the transfer of a given year's loss to the income computation of a later period. Transfer to an earlier period is invariably referred to as a carryback. A generic term denoting the transfer of a loss in either direction does not exist in the literature.

years; France and Uruguay, five years; and Australia, seven years. Most of these allowances are of relatively recent origin.

The inequity of a tax system which does not allow the losses of one year to be offset against the profits of other years is traceable to the annual computation of income. True earnings of a business enterprise are not usually demonstrated by the result for twelve months. The true profit or loss of a concern can be determined with accuracy only over its entire existence. If a company is taxed in years of profit without allowance for losses in other years, its tax burden is out of proportion to the income actually earned over the period. Taxpaying ability does not exist or, at the least, is overstated if a substantial portion of a year's profits is required to cover losses of a prior year.

Annual assessment of income tax does not harm the firm with a consistent record of profits, but the firm whose income record is interspersed with losses suffers discrimination. With respect to payment of taxes, the latter firm is not in an equal position with the former. Indeed, the intermittently profitable firm may have less ability to pay, even with the same net income, since irregularity of income may require greater liquidity and other undesirable business adjustments.

As is generally recognized, there is nothing sacred or scientific about the twelve-month accounting period. Accountants recognize the difficulty of trying to determine the exact income of a particular period. There is a continual overlapping of business transactions from one period to another. Each taxable year of a business does not stand entirely by itself, unassociated with the results of other years.

The use of a single year as the taxable period, without providing for the offset of losses against profits, may convert the income tax into a capital levy. The reason is that the firm whose net income becomes negative is deprived of the right to deduct all the expenses of earning income. In particular, depreciation charges may be wasted during loss years; since depreciation allowances cannot be deferred, the taxpayer may be denied full tax-free recovery of investment in the depreciable asset. So far as the income tax base is concerned, a depreciation charge which merely adds to a loss (computed without the depreciation allowance) is fully wasted.

At the other extreme, an income tax which provides for unlimited offset of losses virtually assures the taxpayer that all expenses will eventually appear as deductions, and it equalizes the treatment of intermittently and consistently profitable firms. An unlimited allowance, however, is both impractical and unnecessary. Income tax administration necessitates the periodic closing of a taxpayer's books, and, as the quantitative evidence below suggests, most firms would achieve complete offset of losses with a fairly brief carryover period.

In most instances, provided that tax rates remain relatively constant, it matters little from the equity standpoint whether losses are carried back against previous profits or forward against subsequent earnings. What is important is that a firm's tax liability be dependent on its true net income, the algebraic result of a period of years, rather than on the haphazard result of strictly annual determination. Both carrybacks and carryforwards satisfy this requirement since either type of offset lengthens the accounting period for tax purposes. However, in order to

accommodate two special cases, a truly equitable carryover provision should permit both types of offset. Firms undergoing liquidation are benefited only by a carryback, and new firms can obtain relief for early losses only if the offset arrangement contains a carryforward element. For going concerns the equity problem is solved by either type of allowance.

Length and Direction of Offset Allowance

The length and direction of the offset period determine the effectiveness with which different carryover arrangements will offset business losses. The longer the period over which losses may be spread, the greater is the likelihood that losses will appear as deductions from taxable income. But, given the length of the period, is the direction of offset significant? Does a carryback have more offsetting power than a carryforward?

Definitive answers to these questions can be obtained only from an extended statistical analysis.[3] Estimates, however, are presented below, based on the experience of sixty large corporations during the interwar period.[4] The principal object of the analysis is to show how these firms would have fared under various hypothetical carryover allowances during the years 1923-1939.[5] The analysis is intended to be illustrative only, and data were chosen for their availability in a form convenient to the present study.

II. A STUDY OF LARGE CORPORATIONS

The original data employed in this study are figures of book net income, an after tax magnitude. For the present computations these figures had to be converted into figures of profit before tax. In a few cases a further adjustment was necessary to remove the influence of loss deductions allowed by law up to the year 1932. For the ten companies so affected the term "profit before tax" represents, therefore, not the amount actually subject to tax, but the net income before loss deductions. For all other companies the two magnitudes coincide. As here used, the terms "profits before tax" and "taxable income" are to be interpreted as income after all charges other than income tax and before deduction of prior losses.

Method and Materials

Table 1 presents an industrial breakdown of the sixty firms, together with summary information of their profits and losses over the entire period studied.

In the aggregate these corporations incurred losses equaling 10.4 per cent of their estimated taxable income. Actual net income (profits minus losses) was therefore overstated by 11.6 per cent. For the textile firms, however, the ratio of losses to profits exceeded 90 per cent —actual net income over the period was

[3] The Treasury has published the results of a comprehensive investigation of this subject in *Business Loss Offsets* (1947). The study is open to question, however, because the materials employed were aggregates of corporate income. A detailed criticism of the Treasury's statistical methods, as well as of other carryover studies, may be found in the writer's dissertation, Ch. 10.

[4] Each of the sixty corporations had assets of at least $5,000,000 as of December 31, 1939 and, with few exceptions, have income records going back to World War I. They form part of a "large corporation sample," made available by the National Bureau, and consist of all firms in the sample that incurred at least one loss in the years 1923-1939. For further details about the selection of firms and adjustment of data, see the writer's dissertation, pp. 164-7, Ch. 11, and appendix.

[5] Wherever necessary, the data were adjusted to remove the effect of the two-year carryforward in force through 1929 and the one-year carryforward permitted for losses of 1930 and 1931.

TABLE 1

PROFITS (BEFORE TAX) AND LOSSES OF SIXTY AMERICAN CORPORATIONS, 1923–1939, AND RATIOS OF LOSSES TO PROFITS, BY INDUSTRIAL GROUPS

(Dollar figures in millions)

Industrial Group	Number of Firms	Profits before Tax	Losses	Ratio of Losses to Profits
(1)	(2)	(3)	(4)	(5)
Manufacturing				
Automobiles and trucks	6	$ 845.7	$ 92.4	.109
Building materials and equipment	7	643.8	40.0	.062
Iron and steel	7	873.1	110.3	.126
Machinery	13	963.0	93.8	.097
Meat packing	4	428.4	38.6	.090
Petroleum	6	1,473.8	121.9	.083
Rubber	2	110.3	25.2	.228
Textiles	7	88.0	81.1	.921
All manufacturing	52	$5,426.1	$603.3	.111
Trade				
Chain grocery stores	1	8.8	0.3	.034
Department stores	4	142.2	24.4	.172
Mail order houses	2	638.7	16.9	.026
Miscellaneous trade	1	10.5	1.2	.114
All trade	8	$ 800.2	$ 42.8	.053
All corporations in sample	60	$6,226.3	$646.1	.104

less than 10 per cent of their taxable income. At the other extreme, the two mail order houses paid tax on an amount only slightly in excess of true income. It should be clear that, in the absence of arrangements for offsetting the losses of one year from the profits of others, the corporate income tax can have pronounced discriminatory effects.

The distribution of loss-to-profit ratios for the individual corporations is summarized in Table 2.

Only nine (15 per cent) of the sixty firms were fortunate enough to have ratios of .025 or less; 27 firms (45 per cent) had ratios exceeding .120; and four firms (all in the textile industry) had negative net incomes (profits minus losses) for the period. Under the annual computation of income tax and in the absence of loss-offset, these four firms would be liable to tax in spite of having experienced a net loss for the period. For the other 56 firms denial of loss-offset means that they pay income tax at an effective rate which is higher than the statutory rate. Their taxable income exceeds actual net income earned over the period.

TABLE 2

DISTRIBUTION OF LOSS-TO-PROFIT RATIOS OF SIXTY CORPORATIONS, 1923–1939

Loss-to-Profit Ratio from to	Number of Corporations	As Per Cent of All Corporations	Cumulative Per Cent
.001– .010	3	5.00	5.00
.011– .025	6	10.00	15.00
.026– .040	7	11.67	26.67
.041– .090	8	13.33	40.00
.091– .120	9	15.00	55.00
.121– .200	10	16.67	71.67
.201– .300	7	11.67	83.34
.301–1.000	6	10.00	93.34
1.001 and over	4	6.66	100.00
	60		

Table 3 presents a year-by-year summary of the profits and losses of the sixty corporations. Ratios have not been computed, but it is evident that, like the firm and the industry ratio, the annual ratio of losses to profits is marked by wide variation.

TABLE 3

PROFITS (BEFORE TAX) AND LOSSES OF SIXTY CORPORATIONS, 1923–1939

(Dollar figures in millions)

Year	Profits before Tax	Losses
1923	$ 424.8	$ 0.0
1924	411.7	10.4
1925	519.7	1.6
1926	563.7	5.3
1927	425.6	16.1
1928	566.7	8.6
1929	655.2	6.3
1930	264.0	27.6
1931	35.7	192.5
1932	10.0	205.2
1933	88.3	72.5
1934	127.3	36.3
1935	289.7	9.3
1936	529.1	2.8
1937	599.2	8.4
1938	246.3	40.8
1939	439.3	2.4
1923–1939	$6,226.3	$646.1

In subsequent tables 1939 losses have been excluded from the computation of losses offsettable under a carryforward. The reason for this exclusion is that, with the study terminating in 1939, losses of that year are completely denied the opportunity to be carried forward. In subsequent tables dealing with carryforwards the aggregate loss figure is, therefore, $643.7 million rather than $646.1 million. A similar rule would have been adopted for 1923 losses in carryback calculations had there been losses in 1923; none of the sixty corporations, however, incurred a loss in that year.

The use of a finite period in the present study (as in every statistical investigation of loss offset) imposes a limitation which is not encountered in the world of experience, namely, losses at either end of the period are denied full opportunity for offset. Because the series begins abruptly, losses in the early years cannot always be carried back; and because the series must eventually terminate, losses of the closing years cannot always be carried forward.[6]

In evaluating the offset arrangements of the present study, it should be noted that the amount of loss designated as offsettable frequently understates the actual amount which can be offset. Except under the one-year carryforward, the offsettable portion of late losses is understated by carryforward figures; and except under the one-year carryback, the offsettable portion of early losses is understated by the results of carryback computations. Since the limitation does not apply to years removed from either end of the period, a central segment of the series will be used for purposes of comparing the carryforward with the carryback.

Carryforward Offsets

Table 4 shows the proportion of each year's losses that would have been offset by carryforward allowances of one to five years. It should be emphasized that, although results are presented for the sixty firms in the aggregate, amounts offsettable under each length of the carryforward were independently computed for each firm.

[6] Full allowance for this technical limitation would necessitate excluding one year of loss for each year of carryback or carryforward permitted. Adherence to such procedure would greatly complicate the task of analyzing loss-offset behavior. Hence, the adoption of the expedient noted above.

For the period as a whole $121.0 million (19 per cent) of the aggregate losses are offset by a one-year carryforward. As the carryforward period is lengthened to four years, an additional 16 per cent (approximately) is offset each year. Extension of the carryforward allowance to five years yields a smaller, yet substantial, increase in the those of 1939. The "entire period" proportions understate the potency of a two-year carryforward to the extent that 1938 losses not offset in 1939 could have been offset in 1940. Similarly, the 76.1 per cent figure for a five-year carryforward would have been greater if the unoffset losses of 1935-1938 had been carried beyond 1939.

TABLE 4

LOSSES OF SIXTY CORPORATIONS, 1923–1938, AND THE PROPORTION OFFSET BY CARRYFORWARDS OF ONE TO FIVE YEARS

Year	Losses (Dollar figures in millions)	Proportion Offset by Carryforward of				
		One Year	Two Years	Three Years	Four Years	Five Years
1923	$ 0.0	..	..	..	..	..
1924	10.4	.13	.14	.17	.39	.48
1925	1.6	.50	.94	.94	.94	.69
1926	5.3	.32	.30	.21	.15	.04
1927	16.1	.09	.64	.71	.71	.71
1928	8.6	.78	.38	.26	.19	.74
1929	6.3	.00	.00	.00	.76	.73
1930	27.6	.00	.00	.00	.24	.45
1931	192.5	.04	.17	.35	.63	.91
1932	205.2	.21	.35	.58	.84	.87
1933	72.5	.15	.53	.86	.92	.87
1930–1933	$497.8	.13	.28	.50	.74	.86
1934	36.3	.41	.82	.77	.32	.35
1935	9.3	.39	.65	.58	.57	..
1936	2.8	.82	.89	1.00	..	..
1937	8.4	.31	.65	..	..	..
1938	40.8	.57	..	..	..	..
1923–1938	$643.7	.19	.35	.51	.68	.76

amount offset, and by this time more than three-fourths of the losses have been offset.

In accordance with the procedure mentioned previously, losses of 1939 are excluded from Table 4. No proportion is shown for 1935 losses under the five-year carryforward, none for 1936 losses under the four- or five-year carryforward, and so on. However, the proportions for the entire period reflect such amounts of the later years' losses as were offset by profits through

The reader may wonder why the proportion offset for a given year sometimes declines as the carryforward period is lengthened. (See, for example, behavior of data for 1926.) The reason is that the offsettable portion of a given year's loss is a function of earlier losses as well as of subsequent profits. Losses must be offset in the order of emergence; and as the carryforward period is lengthened, earlier losses may be brought forward and applied against profits previously used to absorb a later

year's losses. This inverse behavior occurs at least once in every year except 1924 and 1930-1932. It cannot happen for the period as a whole because the aggregate profit against which losses are applied never diminishes.

of aggregate losses for the year under consideration.

By the procedure adopted for the present analysis, losses of the initial year are excluded from carryback calculations. Since no losses were incurred in 1923, however, total losses for carryback purposes coincide with losses of the entire period 1923-1939. Beginning with 1928, losses may be carried back for the full five years. Losses incurred prior to 1928 are limited to briefer carrybacks, depending on their distance from the profits of 1923.

TABLE 5

LOSSES OF SIXTY CORPORATIONS, 1924–1939, AND THE PROPORTION OFFSET BY CARRYBACKS OF ONE TO FIVE YEARS

Year	Losses (Dollar figures in millions)	Proportion Offset by Carryback of				
		One Year	Two Years	Three Years	Four Years	Five Years
1924	$ 10.4	.99	..	..	..	..
1925	1.6	.56	1.00	..	..	..
1926	5.3	.17	.17	.53	..	..
1927	16.1	.65	.81	1.00	1.00	..
1928	8.6	.19	.77	.78	.92	.92
1929	6.3	.00	.21	.21	.21	.33
1930	27.6	.58	.61	.74	.74	.75
1931	192.5	.41	.86	.94	.95	.96
1932	205.2	.08	.59	.85	.89	.92
1933	72.5	.04	.11	.70	.86	.93
1930–1933	$497.8	.23	.62	.86	.90	.93
1934	36.3	.21	.21	.26	.70	.84
1935	9.3	.01	.08	.08	.10	.33
1936	2.8	.11	.11	.11	.11	.11
1937	8.4	.85	.85	.85	.87	.87
1938	40.8	.59	.82	.88	.91	.91
1939	2.4	.00	.46	.75	.75	.75
1924–1939	$646.1	.27	.61	.81	.87	.90

Totals were struck for the years 1930-1933 and proportions were computed to permit comparison of the carryforward with the carryback. This subperiod lends itself to precise comparison because there are at least five years of profit on either side, even within the confines of the present study.

Carryback Offsets

Table 5 shows how the sixty corporations would have been affected by carrybacks of one to five years. As in the case of a carryforward, the amount offset was computed independently for each firm. The amounts were then summed and expressed as a proportion

In evaluating the results for the period as a whole, one must bear in mind that several of the proportions shown (for 1924-1939) understate the potential strength of carrybacks longer than one year. For example, the proportion offset under a two-year carryback would have increased if the unabsorbed portion of the 1924 loss could have been carried back to 1922. Similarly,

the proportion shown for the four-year carryback might have been larger if the unoffset losses of 1926 could have been carried back to 1922. The potency of the one-, three-, or five-year carryback, however, is not understated in the present analysis. All losses have at least one year of previous profits against which they may be applied. The losses of 1925 are completely offset by a two-year carryback and the losses of 1927 by a four-year carryback; hence, the entire period proportions for the three- and five-year carryback, respectively, would not have been increased by making available the profits earned prior to 1923.

For individual years the carryback proportions do not exhibit the inverse behavior characteristic of carryforward proportions. This is so because losses are carried back in the order of emergence and cannot therefore be displaced by other losses.

For the entire period the proportion offset by a given length of carryback is invariably greater than the proportion offset by the same length of carryforward. A one-year carryback, for example, offsets 27.3 per cent of total losses as compared with 18.8 per cent under a one-year carryforward; and a five-year carryback offsets about nine-tenths of the losses compared with the three-fourths offset by a five-year carryforward. Such comparisons are, however, subject to two reservations, one arising from the economic characteristics of the period, and the other stemming from the methodological difficulty already mentioned.

The period 1923-1939 may, for present purposes, be divided into three segments.[7] The first segment, ending in 1929, was characterized by a high level of profits and a relatively small volume of losses. The second segment, extending roughly from 1930 to 1933, was marked by a greatly reduced volume of profits and very heavy losses. In the remaining years profits recovered, though not to the average level of the twenties, and losses subsided from the record volume of the early thirties.

The pattern of profits and losses during the period under study favors the carryback. A larger percentage of the depression losses can be carried back to the profits of the 1920's than can be offset by subsequent profits. Moreover, the heavy losses of 1938 can be carried forward for only one year, while the carryback easily absorbs the bulk of these losses. The apparent superiority of the carryback must be interpreted in the light of this time pattern.

The second reservation is necessitated by technical considerations. The period used for carryforward calculations is not co-terminous with the carryback period. In the former, losses of 1939 are deliberately excluded from calculations, and profits of 1923 cannot be used for offset. For the carryback analysis, profits of 1939 cannot be used, and losses of 1924 are the earliest ones entering into offset calculations. The two systems make use of different sets of profits and losses.

The second, but not the first, obstacle to comparison is surmounted by analysis of the middle section of the series. The apparent superiority of a carryback is here even more pronounced. A one- or two-year carryback now offsets about twice the volume of losses as does a one- or two-year carryforward. More than 90 per cent of these severe losses are offset by a four-year carry-

[7] The division is based on the data of Table 3, p. 73.

back, but not quite 75 per cent by a four-year carryforward.

For the years included in the present study, it is clear that these sixty corporations would have fared better under the carryback than under the carryforward. No generalization is warranted, however, for other periods and other firms.

It is interesting to speculate about the difference in possible effects on corporate policy, owing to the timing advantage of carryback. Under a five-year carryback these corporations would have recouped in tax refunds 75 per cent of their losses of 1930. Under the same length of carryforward they would have received over the subsequent five years tax abatements equal to 45 per cent of their losses. Clearly, the liquidity effects of a carryback in the early 1930's would have been far superior to those of a carryforward. Whether the flow of funds to corporations would have been translated into larger outlays for operations is another matter, one that is beyond the scope of this paper. But there is no doubt that in a gathering depression liquidity considerations favor the use of a carryback rather than a carryforward.

The next section of this paper is devoted to a comparison of two loss-offset arrangements which combine a carryback and carryforward: the two-year-carryback and two-year-carryforward (termed Plan A) and the one-year-carryback and five-year-carryforward (Plan B). The former is the arrangement that was authorized in the United States throughout most of the 1940's; the latter is the system adopted in 1950 and also used currently by Great Britain and Canada. Under either arrangement a loss is first carried back, and any portion of the loss not thus offset is carried forward. In Table 6 the proportion offset by each element of the combination, as well as the combined effect, is shown for each type of arrangement.

For the period as a whole Plan B offsets \$37.5 million more than does Plan A. However, considering that Plan B permits the application of losses against one and one-half years of profit for every year permitted under Plan A, the extra amount offset is not impressive (\$37.5 million is only 5.8 per cent of total losses).

Comparison of either plan with a straight carryforward or carryback is rendered difficult by the requirement that the earliest losses be offset first. Amounts offset by the carryback or the carryforward element of either plan are not necessarily the same as amounts offset by the equivalent length of a straight carryback or carryforward. For example, the amount offset by the carryback element of Plan B diverges from the amount offset by a straight one-year carryback at various points subsequent to 1927. Generally, the former offsets less than the latter. For the period as a whole the straight carryback of one year offsets 27.3 per cent of losses, compared with 23.0 per cent under Plan B. The reason is that the carryforward element of the plan absorbs some of the profits which might otherwise have been canceled by a carryback.[8] Similar divergences are observable when the other elements of either plan are compared with single-direction offset.

[8] The effect is most marked in the case of 1934 losses, where a straight one-year carryback offsets about eight times the amount offset by the carryback element of Plan B.

In summary, the foregoing analysis has disclosed that the amounts of loss offset by the several offset arrangements vary widely, depending on the nature of the offset allowance, the dispersion of profits and losses, and the boundaries of the period under investigation. For the period and firms of the present study, the carryback seemed to have more potency than the carryforward; and the combination of a one-year carryback with a five-year carryforward managed to offset more losses than did the two-year-carryback and two-year-carryforward. The evidence, however, is inconclusive, and a choice among the various systems must take into account factors which are difficult to quantify, such as tax equity and incentive effects.

TABLE 6

Losses of Sixty Corporations, 1923–1939, and the Proportion Offset by Two Carryback-Carryforward Combinations

Year	Losses (Dollar figures in millions)	Plan A Two-Year Carryback and Two-Year Carryforward			Plan B One-Year Carryback and Five-Year Carryforward		
		Proportion Offset by			Proportion Offset by		
		Two-Year Carry-back	Two-Year Carry-forward	Two-Year Carry-back and Two-Year Carry-forward	One-Year Carry-back	Five-Year Carry-forward	One-Year Carry-back and Five-Year Carry-forward
1923	$ 0.0	..	..	..	..	..	..
1924	10.4	.99	.01	1.00	.99	.01	1.00
1925	1.6	1.00	.00	1.00	.56	.44	1.00
1926	5.3	.17	.32	.49	.17	.30	.47
1927	16.1	.81	.08	.88	.65	.14	.79
1928	8.6	.67	.15	.83	.05	.81	.86
1929	6.3	.21	.00	.21	.00	.73	.73
1930	27.6	.60	.00	.60	.57	.27	.84
1931	192.5	.85	.05	.89	.40	.55	.95
1932	205.2	.59	.17	.75	.08	.82	.90
1933	72.5	.10	.47	.57	.00	.78	.78
1930–1933	$497.8	.62	.15	.77	.22	.68	.90
1934	36.3	.03	.80	.83	.03	.67	.69
1935	9.3	.01	.62	.64	.01	.16	.17
1936	2.8	.00	.68	.68	.00	.00	.00
1937	8.4	.52	.35	.87	.32	.20	.52
1938	40.8	.70	.06	.75	.43	.06	.50
1939	2.4	.42	.00	.42	.00	.00	.00
1923–1939	$646.1	.58	.19	.77	.23	.60	.83

Industrial Variations

Table 7 shows the effect of various offset arrangements on the industrial subdivisions of the sample. Table 7 presents for each industry the proportion of losses offset by four offset arrangements and, to facilitate interpretation, the ratio of losses to profits in the absence of an offset allowance.

In those cases where the offset proportion is unity (signifying that the industry has achieved complete offset of losses), the members of the industry are taxed on their true net income, defined as statutory profits minus losses. The loss-offset has eliminated interfirm discriminations arising from the failure to recognize losses as a charge against the taxable income of other years. In all other cases, where the proportion is less than unity, the proportion is an index of the degree to which such discrimination is abated.

For all sixty corporations, from three-fourths to nine-tenths of the discrimination is removed by the selected offset arrangements. The proportions are even higher for the trade component of the sample. The textile corporations, which started with a loss-to-profit ratio of over 90 per cent, receive proportionately less aid than any other group from the various offset schemes. This result is attributable not only to the large volume of losses relative to profits, but also to the greater frequency of losses. One or more textile firms sustained a loss in all but three years of the period (1923, 1936, and 1939). No other industry approximated the unprofitability of the textile industry.

TABLE 7

Ratio of Losses to Profits (before Tax), 1923–1939, and Proportion of Losses Offset by Selected Offset Arrangements: Sixty Corporations and Their Industrial Subdivisions

Industry	Ratio of Losses to Profits *	Proportion of Losses Offset by: Five-Year Carry-back	Five-Year Carry-forward	Plan A	Plan B
Manufacturing					
Automobiles and trucks	.11	.85	.56 †	.62	.62
Building materials and equipment	.06	.94	.80	.73	.81
Iron and steel	.13	1.00	.89	.81	.93
Machinery	.10	.93	.74 †	.80	.82
Meat packing	.09	1.00	.90	1.00	.95
Petroleum	.08	.99	.97	.89	1.00
Rubber	.23	1.00	.78	.77	1.00
Textiles	.92	.51	.40	.52	.53
All Manufacturing	.11	.89	.76 †	.76	.82
Trade					
Chain grocery stores	.03	.67	1.00	1.00	1.00
Department stores	.17	1.00	.65	.73	.86
Mail order houses	.03	1.00	1.00	1.00	1.00
Miscellaneous trade	.11	1.00	1.00	.67	1.00
All trade	.05	1.00	.80	.84	.92
All corporations	.10	.90	.76 †	.77	.83

* Reproduced from Table 1.

† The proportions do not reflect the 1939 losses incurred by Hudson Motor Co. ($1.4 million) and American Locomotive Co. ($1.0 million).

III. ECONOMIC EFFECT OF LOSS OFFSET

The foregoing statistical investigation showed how a small group of firms would have fared under various carryover allowances during a given histori-

cal period. The remaining paragraphs summarize, more or less systematically, some of the general economic effects of loss offsets. It is emphasized, however, that the conclusions are to be regarded as tentative; our knowledge of the interplay between this feature of the tax law and business decisions is as yet not adequate for definitive judgments.

Three areas in which the influence of loss carryovers is relatively clear-cut have been selected for fairly extended analysis: investment in enterprises where risk of loss is relatively great; the problem of stabilizing business expenditures; and the impact upon the distribution of entrepreneurial resources. Three other problems are treated briefly in the final section.

Effects upon Risk-Taking

When a government imposes a tax on business income and does not permit an interperiod offsetting of losses, risky enterprises (defined as ventures which occasionally experience losses) are penalized as compared with business ventures which consistently show a profit. The firm (or industry) with alternating profits and losses will, in the absence of a loss carryover, be taxed at a higher rate on its algebraic net income than will the firm (or industry) with an uninterrupted record of profits. Thus, an income tax not containing liberal carryover provisions tends to discourage investment in ventures characterized by a relatively high risk of loss.

By imposing a tax without loss offset, the government appoints itself a partner which will share in the gains but not in the losses associated with risk-taking. The government's participation in the partnership depends upon the result of annual income determination. If the outcome is a positive figure, the government steps in for a share of the gain; if the year's operations produce a red figure, the government temporarily withdraws from the partnership.

If, on the other hand, the tax law permits an unlimited offset of losses, the government's role becomes that of a full partner which shares losses and profits on the same terms. The extent of government participation in both profits and losses is measured by the tax rate. With respect to the allocation of investment funds as between risky and nonrisky investments (enterprises which do and do not entail the risk of periodic losses), an unlimited offset means that the tax penalty against risky investment is removed. The investor still has to choose from among investments with varying degrees of risk, but his choice is no longer disturbed by government participation in his earnings. Under conditions of full offset, the tax falls only on true income, that is, on the algebraic net income of the averaging period.

Between these limiting cases of zero and complete offset lie the infinite possibilities of partial offset of losses which are illustrated by Tables 4 to 6. Where the tax law permits offset for a limited period on either side of the loss, the impact upon risk-taking depends on the proportion of losses which can be absorbed. If only a minor fraction of the losses can be offset, either because the carryover period is too brief or because the losses are unfortunately spaced, the results will approach those obtaining in the case of no offset. A liberal carryover allowance, permitting the absorption of 80 or 90 per cent of losses, will produce results similar to those expected

from unlimited offset. To the extent that offset is incomplete, the tax law still discriminates against risky investment; but the severity of the penalty is largely abated. In the case of partial offset the government's role as a partner in the enterprise becomes asymmetrical: it receives a full share of profits but assumes only partial responsibility for losses. The government's share in profits is equal to the tax rate; its share in losses is equal to the tax rate times the proportion of losses that can be offset.

Income effect versus substitution effect: the Domar-Musgrave fallacy. Readers acquainted with the Domar-Musgrave analysis[9] of this subject may have detected a contradiction between the conclusions reached in that analysis and the observations made in this paper. With respect to the case of unlimited offset, Domar and Musgrave "reach the important and somewhat unexpected conclusion that the imposition of the tax [under conditions where complete offset of losses is possible] will increase the total risk taken."[10] The implication of the present analysis is that, where full offset is possible, the amount of risk-taking will recover to the level achieved before imposition of the tax. Risk-taking is discouraged by a tax which does not permit the complete offset of losses, but the introduction of an unlimited loss carryover simply restores the pretax equilibrium between risky and nonrisky investments.

The contradiction is, however, more apparent than real; it rests on a distinction drawn by Domar and Musgrave between the *substitution* effect and the *income* effect of taxation with a full loss offset. The reasoning behind the Domar-Musgrave conclusion quoted above is briefly as follows:

> The full-offset allowance means that the tax will reduce yield and risk by the same proportion. Initially at least, the investor will have no reason to substitute less risky for more risky investment. But the tax has reduced the investor's disposable income. In order to recapture his former spending position, he may decide to shift to higher-risk investments which carry a higher yield. ("The income effect will make the investor shift to an asset combination with higher risk.") The increased risk taken by the investor (private risk) added to the risk borne by the government (public risk) results in an increase of total risk taken.

Up to the initial substitution effect, there is no divergence between the Domar-Musgrave conclusion and the present writer's analysis. It is agreed that full offset removes the incentive to shift to "less risky" investments. Domar and Musgrave, however, go a step further and introduce secondary effects. The quest for more income (the latter having been reduced by the tax) will cause the investor to rearrange his portfolio in favor of the more risky investments which produce a higher yield. It is the income effect, therefore, which is responsible for any increase in risk-taking that may occur.

In their article Domar and Musgrave have done much to clarify the relation between taxation and risk-taking; but their conclusion regarding the case of full offset can, if not critically appraised, lead to unwarranted optimism about the potency of a loss carryover. The impression created by their language is that, if complete offset of losses

[9] Evsey D. Domar and Richard A. Musgrave, "Proportional Income Taxation and Risk-Taking," *Quarterly Journal of Economics*, May, 1944, pp. 388-422.

[10] *Ibid.*, p. 411.

is possible, the normal consequence of imposing a tax will be an actual increase of risk-taking in the economy. In the opinion of the writer, this view is fallacious. The best that can happen is that the amount of risk-taking will not decline. Full offset counteracts the tendency of strictly annual taxation to discourage risk-taking, but it does not seem probable that this tax device will initiate an expansion of risk-taking.

As has been pointed out, the alleged increase of risk-taking in the Domar-Musgrave analysis stems entirely from the income effect which they describe. It seems to the present writer that the income effect does not deserve equal consideration with the substitution effect. The latter effect is more or less certain and follows logically from the assumption of a full offset; the income effect may never materialize. It will materialize only if the investor is willing, after imposition of the tax, to assume more risk than he was prepared to take in the absence of taxation. This involves a change in his preferences among investments with different degrees of risk. An assumption which is at least as reasonable is that the investor had achieved the optimum allocation of his investable funds prior to imposition of the tax; and since the tax law does not discriminate against risky investments, he is not motivated by the tax to change the disposition of his funds. If, as Domar and Musgrave assume, he decides to increase his before-tax income by switching to higher-yield (and higher-risk) assets, his decision is properly attributable to a revised estimate of the relative desirability of risky investments, not to the tax law or its loss-offset feature.

In fairness to Domar and Musgrave it should be pointed out that their analysis is organized in terms of the investor's response to taxation and is based on a number of simplifying assumptions fully spelled out. The present writer's treatment is aimed merely at a preliminary statement of how the return on risky investment is affected by loss carryover. The way in which the investor reacts to these changes depends on other variables not here considered. Whatever the approach, it is plain that a tax system with generous loss-offset allowances provides more incentive for risk-taking than a system wherein the taxpayer shoulders the losses entirely by himself.

Stabilization of Business Spending

A second area in which loss offsets provide beneficial economic effects is that of business spending, characterized by wide fluctuations over the business cycle. When income is assessed on a strictly annual basis, businessmen are encouraged to time their outlays so that the deductions are taken only in years of profit. In years of loss or impending loss, expenditures are held to a minimum because the businessman gets no benefit from the deduction. A tax system without adequate provision for loss offsets, therefore, promotes instability in business spending.

Timing is especially important (under the system of annual determination) with respect to outlays for plant and equipment. The cost of these assets must be spread over a period of years, and if any one of those years proves to be unprofitable (before allowing for depreciation), that year's depreciation deduction will be wasted. This means

that the businessman will be unable to recover tax-free his investment in the asset. When a depression strikes, businessmen are encouraged by the annual assessment rule to curtail or even cancel their investment plans; conversely, they are encouraged to concentrate their capital outlays in the upswing of the business cycle.

Under a system where a complete offset of losses is possible, the incentive to arbitrary timing of investment disappears. Depreciation charges are no longer wasted because the deduction belonging to a loss-year reduces taxable income of some other year (or years). Being assured that his investment will be recovered free from tax, the businessman is no longer under pressure to postpone outlays until recovery is in sight. The influence of this factor may be negligible during a cataclysm such as that of the early thirties, but in a less severe contraction it may be controlling. In any case, a generous offset allowance should dampen the fluctuations which characterize this important economic variable.

Either a carryback or a carryforward tends to stabilize business expenditures insofar as instability stems from fear that deductions will be wasted. But a carryback does the job with greater certainty—by reducing income on which taxes have already been paid. To realize a financial benefit from a carryforward, the businessman incurring a loss must wait until his business again shows a profit. If he is contemplating a large expenditure in a doubtful period, it is more reassuring to know that any loss which develops will bring an immediate refund rather than a tax abatement at some future date. With a carryforward he cannot even be sure that the benefit will still be available when he is ready to deduct the loss since Congress may intervene with repeal or modification of the carryforward allowance. Late in 1932 businessmen found out that losses of 1930 and 1931 were eligible for only one year of carryforward instead of two years; and in the spring of 1933 they learned that losses of 1932 were completely ineligible for carryforward.

Liquidity considerations. As an antidepression measure, a carryback has another important advantage over a carryforward: it provides funds when cash is most needed. Following a downturn in business activity, the businessman may be forced by a shortage of working capital to curtail operations, defer maintenance, and, in the case of corporations, postpone dividends. Credit may be difficult to obtain at this juncture in the business cycle. The prospect of a tax refund may enable him to obtain a loan and thus weather the crisis. A carryback acts as a cushion in times of financial adversity.

Carryforwards, on the other hand, bring no financial relief to the businessman during depression (the loss-years) and may prove troublesome to the economy when the benefits are actually pocketed by businessmen. If business recovers rapidly after a period of sustained losses, the tax abatements from carryforwards are concentrated in the early years of the upswing. The extra cash in the hands of businessmen constitutes an inflationary threat since it may be spent before goods and services are available to satisfy demand.

Liquidity considerations, therefore, as well as the factor of greater certainty,

point to the carryback as the superior weapon for steadying business expenditures. Some notion of the contracyclical power of the carryback may be gained from the data in Table 5, page 75. Under a five-year carryback, for example, the firms examined would have offset 75 per cent of their 1930 losses and realized immediate, substantial refunds. For comparison, a five-year carryforward would have offset only 45 per cent of the same losses, the benefit accruing to the firms in 1935. The Treasury, however, took a skeptical view of the contracyclical power of carryovers a few years ago:

> It appears that carrybacks may stimulate business expenditures during a depression to a slightly greater extent than carryforwards. It seems unlikely, however, that the difference between carrybacks and carryforwards in this respect will be very great, or that either carrybacks or carryforwards will have an important countercyclical effect.[11]

Impact upon the Allocation of Resources

In a private enterprise economy business losses serve as a guide to the allocation of resources. If an industry is plagued by persistent losses, firms move out of that industry and, wherever possible, capital is transferred to a profitable sector of the economy. Unemployed venture capital, seeking a source of employment, is diverted from industries characterized by chronic loss. So long as the tax law does not provide relief for loss-incurring firms, the resource-allocating function of losses operates without interference; but once a loss carryover provision appears in the law, the natural movement of capital is modified, the modification depending upon the directional emphasis of the provision.

Misallocations under carryback. The carryback, which was previously shown to be a promising antidepression device, is also a source of support to inefficient firms. A firm that sustains losses because of managerial incompetence is able to prolong its existence by taking advantage of carryback benefits. Left to its own resources, the firm might eventually be forced to liquidate; but a carryback diverts funds to the ailing concern and enables it to continue in operation beyond its natural life. The tax refund paid to the inefficient firm may have come out of taxes paid by some profitable member of the business community. If so, the effect of the carryback in this case is a clear misdirection of resources—from a productive to an unproductive sector of the economy.

Carrybacks also act as a deterrent to the formation of enterprise. A new firm cannot avail itself of a carryback since it has no prior income against which initial losses may be applied. If it seeks to enter a competitive industry, it is placed at a disadvantage compared with the established firms of that industry. Should losses become general in the industry following the new firm's entry, the old firms will be able to finance their losses in part with tax refunds; but the new firm must stand its losses alone. Carrybacks thus provide a competitive advantage to the established firms even though they may be less efficiently managed than the new firm.

[11] United States Treasury Department, *Business Loss Offsets* (1947), p. 7.

Carryforwards and the promotion of enterprise. Carryforwards, on the other hand, encourage the formation of new firms by diverting to government part of the burden of initial losses. Similarly, carryforwards promote the expansion of existing firms into new lines of production. The stimulating character of the carryforward is undoubtedly its most conspicuous merit and has been much emphasized since the restoration of the carryforward allowance in 1939. The amount of new enterprise in the past decade which is attributable to the loss carryforward cannot be measured, but the carryforward is clearly one of the most attractive incentives that can be built into a tax system. It is noteworthy that the Shoup Mission to Japan recommended an unlimited carryforward allowance as a means of stimulating the revival of Japanese industry in 1950.

Unlike the carryback, the carryforward puts the new and the old firm on an equal footing. Whereas the carryback impedes the entry of new firms into a competitive industry, the carryforward assures the newcomer of equal benefits under the tax law in case of early losses. Should one of the old firms be relatively inefficient, the carryforward removes the advantage which that firm would have under a carryback.

The superior ability of the carryback to counteract depression must be weighed against the inferior quality of resource allocation which it produces. The carryforward is less useful as a countercyclical device, but it minimizes the possibility of an undesirable distribution of resources. A choice between the two devices depends upon further considerations, among them the question of whether control of depressions is more important than the promotion of new enterprise.

A SURVEY OF THE RESEARCH AND ANALYSIS ACTIVITIES OF THE FEDERAL GOVERNMENT IN THE FIELD OF TAXATION *

THIS REPORT presents brief descriptions of the principal activities of the federal government relating to the research and analysis of federal, state, and local taxation. An attempt has been made to include all agencies which regularly conduct work in this field, except those dealing exclusively with administrative, legal, and enforcement aspects of taxation.[1] The report does not cover agencies which simply use the results of research and analysis on taxation done by others, or which develop information useful for tax analysis purposes, but do not themselves engage in such analysis. With a few exceptions, agencies which occasionally handle tax matters but do not have special tax staffs are not included.

The chief concentration of tax research and analysis in the federal government is in the Treasury Department, which has major responsibility within the executive branch for determining tax policies. A few additional agencies in the executive branch, as well as the staffs of some congressional committees, participate in the formation of broad tax policies and make studies for this purpose. In most other cases, however, agencies investigate tax matters not because of their responsibility for tax policy questions as such, but rather because the information is needed in connection with the operation of their own programs or in connection with the collection and analysis of related types of data. The main interest of several of these agencies is in state and local, rather than federal, taxation.

The purpose of the present report is strictly informational. It was prepared primarily for the use of the agencies which are covered. Tax issues are involved in so many different phases of federal activities that it is sometimes difficult to determine which agencies are interested in particular matters and where to turn for assistance. The *Federal Statistical Directory* and other publications of this type are only of limited usefulness in this respect.

The information in this report is based in large part on statements submitted by the respective agencies. It was decided to group the agencies according to major subject areas, although this results in somewhat arbitrary groupings for a few agencies with activities in several areas. Footnotes are used to call attention to agency activities which are described under more than one subject heading. In most cases the size of the staff assigned to tax work is indicated, and examples are given to illustrate the types of projects undertaken.

* This report was prepared by Haskell P. Wald, a member of the staff of the Council of Economic Advisers in the Executive Office of the President. It was completed in November, 1952 and distributed to federal personnel by the Council of Economic Advisers. It is published here in the belief that the information it contains will be useful to many persons outside the federal government. This is the first time that descriptive material on the various activities of the federal government in the tax field has been assembled in this convenient form. For valuable additional information on this subject, the reader is referred to *The Federal Taxing Process*, by Roy Blough (New York: Prentice-Hall, 1952), especially Ch. 5, "The Executive and Tax Legislation," and Ch. 6, "The Expert and Tax Policy Making."

[1] Among the more important agencies not covered are the Bureau of Internal Revenue, the Tax Legislative Counsel in the Office of the General Counsel for the Treasury, and the Tax Division, Department of Justice.

I. FEDERAL TAX POLICY

A. *Treasury Department, Tax Advisory Staff of the Secretary*

The principal responsibility of the Tax Advisory Staff is to undertake comprehensive economic analyses for use in the formulation of the Treasury's tax policies. Most of the detailed work which goes into the preparation of each year's revenue program, including the submissions to congressional committees, is done in this office.

The staff develops all nonlegal, nonadministrative tax studies for the Treasury, with the exception of revenue estimates.[2] These studies cover the operation of existing taxes, proposals for changes in these taxes, and possible new revenue sources. Attention is also given to state and local taxes in relation to federal tax problems and to the interrelationship between the United States and foreign tax systems. The staff regularly assists the Treasury's Tax Legislative Counsel and the Bureau of Internal Revenue. Much of the staff work is published in the hearings of the congressional tax committees or as Treasury tax studies.

When fully staffed, the Tax Advisory Staff includes 14 economists plus clerical, administrative, and secretarial personnel. A few outside consultants participate on an intermittent basis.

B. *Executive Office of the President*

1. *Council of Economic Advisers.* The Council is interested in taxation from the standpoint of how tax policy might be used to promote economic stability and growth. One staff member is responsible for working with other agencies in the tax field and assembling material which will aid in developing tax policy recommendations. This person drafts sections on tax and fiscal policies for the Council's semi-annual reports and handles various other assignments in this general subject area.

2. *Bureau of the Budget.*[3] Decisions on tax policy are an essential part of the overall budgeting process administered by the Bureau of the Budget. The annual budget message, for example, generally includes the broad outlines of the administration's tax program.

At various stages in the preparation of the budget estimates, it is necessary to be guided by assumptions as to future tax policy and revenue and by analyses showing budget receipts under alternative conditions. These and other questions of this nature are handled by a few fiscal analysts working under the Economic Adviser in the Office of Budget Review. The Budget Bureau has no staff dealing exclusively with taxation.

C. *Board of Governors of the Federal Reserve System, Division of Research and Statistics*[4]

The Government Finance Section, which is in the Division of Research and Statistics, includes one economist who carries the chief responsibility for research on broad issues of tax policy. Particular attention is given to the effects of deficits or surpluses on the money market. In addition, regular reports are prepared on the government's fiscal operations and on new revenue legislation.

Tax studies may be undertaken because they are important for specific policy issues under consideration by the Board, or because of the continual interest of the Federal Reserve staff in tax and fiscal developments. In the recent past, for example, an analysis was made of the provisions of the excess profits tax law which provide an incentive for corporations to borrow additional capital, and a detailed appraisal was made of the latest studies on the distribution of the tax burden by income level.

D. *Joint Committee on Internal Revenue Taxation*[5]

The staff of the Joint Committee consists of 20 professionals plus administrative and secretarial members who have been appointed on the basis of their technical qualifications and experience and without regard

[2] Revenue estimates are the responsibility of the Office of Technical Staff. (See II-A below.)

[3] Also, see II-B and VII-A below.

[4] Also, see II-C below.

[5] Also, see II-D below.

to political affiliation. The professional personnel of the staff consists of lawyers, economists, accountants, statistical analysts and assistants, all under the direction of a Chief of Staff who reports directly to the Chairman of the Committee.

The staff is concerned with over-all tax policy, special legal and technical aspects of revenue legislation, the review of tax refunds, and the preparation of revenue estimates. The over-all tax policy at the staff level is only determined after full staff conferences in which all groups participate, that is, economists, lawyers, accountants, and statistical analysts. This procedure is generally followed in the preparation of individual reports. Usually two or three staff members are assigned to develop a report, the staff members chosen being specialists in different professions or callings. Various joint projects are undertaken with the Treasury Department, usually in response to requests from the congressional tax committees.

An annual summary of the President's budget proposals and reviews of the British and Canadian budgets are prepared by the staff economists, statistical analysts and their assistants, and reviewed by the Chief of Staff prior to publication.

E. *Joint Committee on the Economic Report*

A major concern of the Committee's research staff is with fiscal policy questions, and several comprehensive reports have been published which develop the economic implications of alternative tax programs for the federal government. In general, these reports set forth detailed projections of the nation's economic budget for the following fiscal year, including receipts and expenditures of the federal government, state and local governments, private business, and consumers. Alternative programs of federal action are prepared in order to assist the Committee in developing its recommendations to the Congress. While these studies are under way, numerous conferences are held with economists in the executive agencies and in business and the universities.

One staff member spends close to full time on specific tax problems arising out of pending or proposed revenue legislation. The staff makes frequent use of outside consultants, as in the case of the recently issued study of sec. 102 of the Internal Revenue Code, and obtains considerable assistance from the Legislative Reference Service of the Library of Congress.

F. *Library of Congress, Legislative Reference Service*

The staff of specialists of the Legislative Reference Service includes a "senior specialist on taxation and fiscal policy" who, together with an assistant, prepares special analyses and reports on taxation and fiscal policy for members of Congress and for various congressional committees. In addition, he often is drawn into the work on current revenue legislation.

Requests of a more routine nature, or those which involve extensive statistical work, are handled by a public finance staff consisting of two economists in the Economics Section.

II. REVENUE ESTIMATES [6]

A. *Treasury Department, Office of the Technical Staff*

A group of economists and statisticians within the Technical Staff regularly prepares current projections of probable Treasury cash receipts for use in connection with the Treasury's financing requirements. In addition, the group makes revenue estimates for the January budget message of the President and interim revisions thereof.

[6] Several agencies prepare revenue estimates in conjunction with projections of the national income and gross national product. The following agencies are most active in this work: (1) Department of Commerce, Office of Business Economics; (2) Board of Governors of the Federal Reserve System, Division of Research and Statistics, National Income, Moneyflows, and Labor Section; and (3) staff of the Joint Committee on the Economic Report. There is close interagency cooperation in this estimating work.

Estimates of the effects of proposed and existing legislation also are prepared for use during consideration of possible revisions in the revenue laws.

B. *Executive Office of the President, Bureau of the Budget*[7]

One staff member, working under the Economic Adviser in the Office of Budget Review, examines and revises for internal use the revenue estimates published in the annual budget messages and the intervening budget revisions. Also, for internal purposes, it is often necessary to extend the revenue estimates beyond the period covered by the published reports and to study the variations in revenue that might be associated with alternative expenditure programs and alternative assumptions as to future business conditions.

C. *Board of Governors of the Federal Reserve System, Division of Research and Statistics*[8]

The Government Finance Section includes two professional statisticians and two statistical clerks who maintain estimates of the Treasury's cash requirements by weeks and months for the period immediately ahead. These estimates are needed in connection with Federal Reserve open-market operations for the guidance of monetary and credit policy, and they must be kept on as current a basis as possible.

Long-run revenue estimates are also prepared, showing Treasury receipts under existing tax rates and under certain assumed changes in the legislation. Such estimates are required as background information for various Federal Reserve programs.

D. *Joint Committee on Internal Revenue Taxation*[9]

Revenue estimates are prepared on the basis of a level of economic activity covering a period of at least 18 months. Conferences are held in Washington with business and professional men from various parts of the country in order to obtain their views and reasons therefor on the business outlook. Separate conferences are held with economists and others engaged in economic forecasting in the executive departments. As a result of these conferences, estimates of economic activity are developed at staff meetings held by the Chief of Staff with the staff statistical analysts and staff economists. After the basic figures have been developed, the revenue estimates are prepared by the statistical analysts and their assistants. These estimates are generally released in March or early April.

In addition to regular estimates for each year's budget and successive budget revisions, many special estimating assignments are undertaken in connection with proposed legislation, and the estimates usually are published in the revenue hearings or in Committee reports, or they appear in press releases.

III. TAXATION OF AGRICULTURE

A. *Department of Agriculture, Bureau of Agricultural Economics*

The Division of Agricultural Finance includes a Tax Section staffed with seven persons, including four taxation economists. An important activity of the Section is to prepare estimates of taxes paid by farmers. Statistical series are maintained showing amounts paid by farmers for the following taxes: (a) farm real estate and farm personal property taxes; (b) federal and state automotive taxes; and (c) federal income taxes. The tax-per-acre series is included directly in the computation of parity prices, while the other series enter into the computation of farm costs and farmers' disposable income. The estimates of taxes paid by farmers also are used for studying the tax load on agriculture and comparing tax levels in various states.

The Section cooperates with the Bureau of Internal Revenue with respect to provisions and regulations in the federal income tax law as they relate to farmers. Proposed

[7] Also, see I-B-2 above and VII-A below.

[8] Also, see I-C above.

[9] Also, see I-D above.

changes in taxes affecting agriculture are analyzed, and various types of assistance are provided to other agencies and outside groups who work with farm tax problems. The Section also helps with projects that do not involve taxes primarily, but which have important tax implications. It also assists the states and regions in the study of farm tax problems, particularly those related to inequities in property taxation.

In addition, special research projects are undertaken in the broad area of the impact of federal, state, and local fiscal policies on agriculture. Studies have been undertaken on the distribution of tax burdens among farmers at different income levels, homestead and veterans' exemptions in property taxation, and federal aids to agriculture.

B. *Department of Agriculture, Forest Service*

The Forest Economics Division is responsible for studies on problems of forest finance, including taxation, insurance, and credit. The chief tax problems in this field arise out of state and local taxes. Occasional studies are made of the impact of federal taxes on the production of timber and other forest products. For example, a recent study interprets the capital gains provisions of the federal income tax law as they affect timber owners.

Current tax legislation is followed and proposals of forestry interest are analyzed. Consideration is given to questions relating to federal financial contributions to local governments on account of lands in federal ownership.

A state forest tax law digest is issued periodically.

C. *Department of Agriculture, Extension Service*

The Extension Service, in cooperation with the state extension services, conducts educational activities on various tax matters, including federal income tax provisions for farmers, state and local tax problems, and taxation for cooperative businesses. As part of the income tax work, the staff prepares three regional informational bulletins each year, which are approved by the Bureau of Internal Revenue.

Educational work on state and local tax matters varies considerably between states, but it includes land classification for tax assessment purposes, local governmental costs, sources of the tax dollar, tax provisions for forest lands, etc. The work on the taxation of cooperatives consists largely in developing a better understanding of what taxes are paid by cooperatives and how patronage dividends, income taxes, etc., are handled.

As a part of the Extension Service's general program to promote understanding of public problems and policies, material is developed on the relation of taxation to inflation and other broad issues of federal tax policy.

D. *Department of Agriculture, Farm Credit Administration*

Although the Administration does not have any staff to study taxation on a continuing basis, important tax questions arise in connection with analyses of such subjects as farm income and farm land values. Special staff assignments are made as required by the problems at hand.

The taxation of agricultural cooperatives is an important phase of the work of the Cooperative Research and Service Division.

IV. TAXATION OF EXTRACTIVE INDUSTRIES

Department of Interior, Bureau of Mines

The Office of Chief Economist includes one economist who studies the economic effects of federal, state, and local taxes on the various mineral industries. In addition, this staff member handles various research assignments which involve the effect of taxation on other industries and programs for which the Department carries important responsibilities.

The Office is responsible for following current tax legislation and analyzing those proposals which have special implications for the extractive industries.

V. TAXATION OF SMALL BUSINESS

A. *National Production Authority, Office of Small Business*

Developments in business taxation, with particular reference to the impact of taxes on small business, are reviewed in the Impact Analysis and Reports Division. Tax proposals and legislation of particular significance to small, new and growing enterprises are analyzed in terms of their likely impact on the small business community. This work is a continuation of the tax analysis formerly conducted by the Department of Commerce, Office of Industry and Commerce. Currently, two staff members give part of their time to tax problems. As the economic analysis activities of the Office relating to problems of materials control decrease, it is anticipated that more and more time will be given to the study of tax problems and the formulation of tax policy recommendations.

The staff has assisted the taxation subcommittee of the Senate Select Committee on Small Business.

B. *Senate Select Committee on Small Business*

This Committee includes a Subcommittee on Taxation which is investigating the impact of federal taxes on small businesses. At the completion of the hearings, which are being held in different cities, the Subcommittee will prepare a report setting forth its conclusions and recommendations for tax changes. One staff member is assigned to work with the Subcommittee.

VI. SOCIAL SECURITY FINANCING

A. *Federal Security Agency, Social Security Administration*

The Division of Research and Statistics, Office of the Commissioner, no longer has staff for a continuing program of research on the payroll taxes and other means of social security financing. Its work in the tax field is now limited to participation in analyses related to the statutory requirement for five-year forecasts of the status of the Old-Age and Survivors Insurance Trust Fund and to special projects dealing with the problem of expanding and improving the social security system. The Division prepares annual estimates of contributions under old-age and survivors insurance, unemployment insurance, civil service, railroad retirement, state and local retirement, and the state temporary disability insurance programs.

In the past the Division made extensive studies of the fiscal capacity of states and of proposals for variable grants-in-aid. (This work is now done largely in the agencies listed under VII, below.) Some work is still being done on problems relating to grants-in-aid for public assistance, the Children's Bureau programs, and the proposals for national health insurance—such as allocation formulas, countercyclical grants, problems of intrastate equalization, etc. A monograph is being prepared which will provide general background information and analysis of revenue sources used to finance social security programs, the contributory basis of social insurance financing, reserve and trust fund problems, grant-in-aid problems and policies, and the place of social security programs in the national economy.

Problems of social security financing are also studied in the Division of Program Analysis, Bureau of Old-Age and Survivors Insurance. Estimates of revenues for the five-year forecasts mentioned above are prepared in the Economic Studies Branch. One staff member is assigned to tax policy studies, such as the survey of financial policy in old-age and survivors insurance from 1935 to 1950, published in the Social Security Bulletin.

The Office of the Actuary of the Social Security Administration carries out continuing actuarial studies and analyses of existing and proposed social security programs. These studies include data on the expected yield of the payroll tax.

The Bureau of Public Assistance carries out studies of alternative grant-in-aid formulas for the public assistance programs and collects some information on state and local taxes earmarked for public assistance purposes.

B. *Department of Labor, Bureau of Employment Security*

Actuarial studies of the unemployment insurance program are made in the Division of Actuarial and Financial Services, Unemployment Insurance Service. These studies include analyses of the expected yield of the payroll taxes. Frequent analyses are made of the economic effects of the taxes and of the operation of the taxes in particular states, but the Division does not have a special tax research staff.

VII. STATE AND LOCAL TAX SYSTEMS

A. *Executive Office of the President, Bureau of the Budget* [10]

One staff member in the Labor and Welfare Division is assigned to state and local fiscal matters. He follows tax, expenditure, and debt policies of state and local governments and analyzes the implications of these policies for federal fiscal programs. He also handles intergovernmental fiscal coordination problems.

B. *Department of Commerce, Bureau of the Census*

The Governments Division provides, on a continuing basis, statistical information on governmental finances and employment, with particular reference to state and local governments. Most of the 30 staff members assigned to the compilation of financial statistics are occupied with the preparation of annual information on revenue, expenditures, and debt for state governments and cities with a population of over 25,000. Other reports provide basic revenue and debt estimates for all governmental units. The annual reports on "Governmental Revenue" provide summary national totals by type of government, showing major tax sources. The annual series on state and city finances make available comparative data in detail for individual states and large cities. An important by-product of this work is the stimulus and direct assistance given to state and local governments to adopt uniform classifications for their financial reports.

At periodic intervals—most recently for 1942—the Division undertakes a complete "census of governments," reporting detailed information for all governmental units. Among the special reports issued by the Division in the past are reports on property taxation, assessed valuations, public-service enterprises, state aid to local governments, and retirement systems for state and local employees.

The Division does not have sufficient staff to conduct extensive analyses of the data collected.

C. *Department of Commerce, Bureau of Public Roads*

The Taxation Studies Unit of the Taxation and Economics Section, Financial and Administrative Research Branch, comprises three professional employees who analyze problems of highway financing and taxes imposed on highway users. This work relates largely to state and local taxes. The Unit cooperates closely with the Highway Research Board (a constituent agency of the National Academy of Sciences) and the American Association of State Highway Officials.

The Financial Studies Unit, Financial and Administrative Studies Section, Financial and Administrative Research Branch, annually collects and analyzes information about the financing of highways by counties and local governmental units. It also prepares periodic estimates of the total funds raised and spent by all levels of government for highway purposes, and issues occasional research reports on various phases

10 Also, see I-B-2 and II-B above.

of highway finance, such as city-street financing and borrowing to finance highway construction. The Unit includes two professional employees.

The Highway Statistics Section, Research Reports Branch, compiles and publishes annual data on such matters as state taxation of motor fuel and motor vehicles, and it also collects information on federal excise taxes relating to motor vehicles and their use. In connection with these activities, the Section prepares and publishes tabulations of state highway finances which show both the nature of the disbursements made and the major sources, including federal aid, from which the funds spent were derived. The Section publishes articles and reports which analyze these statistics.

D. *Federal Security Agency, Public Health Services*

Data relating to the fiscal ability of state and local governments to finance public health services are assembled by the Analysis and Reports Section, Division of State Grants, Bureau of State Services. Federal legislation specifies financial need as one of the criteria to be used in apportioning public health grants. State monies also are frequently apportioned on the basis of the financial need of the localities, and the Public Health staff assists the states in developing adequate measures of such need.

Much of the necessary information on tax rates, property tax assessments, and similar matters is obtained directly from the state and local governments.

E. *Federal Security Agency, Office of Education*

The School Administration Branch in the Division of State and Local School Systems cooperates with the state and local school authorities on studies of status and methods of financing their educational programs, including the current expense as well as the capital outlay phases. Frequent attention is given to problems of measuring the ability or capacity of the states and the local school districts to finance school programs and to the improvement of apportionment procedures.

Intensive work has been done on the problem of " in lieu " payments, and a program of making payments to school districts which have been affected by the federal purchase of formerly taxed property and by other federal activities is now in effect.

F. *Tennessee Valley Authority (Knoxville, Tennessee office)*

Public finance trends in the seven states in the TVA area are closely studied in the Government Research Branch. This work, carried on by a staff of two professional persons, provides information regarding the capacity of local and state governments to participate in resource development. Such research is also needed in connection with the determination of payments made in lieu of taxes.

The Branch also prepares studies of public utility taxation.

G. *Housing and Home Finance Agency*

This Agency is responsible for a number of different programs, each concerned with local taxation from a different viewpoint. As a result, the work of this Agency in the field of taxation is carried out in several offices.

The Housing Finance Branch, Division of Housing Research, in the Office of the Administrator has a continuing interest in this field, but staff resources presently limit investigations to special problems, such as making estimates of the average cost of local real estate taxes per dwelling unit as a component of the necessary rent or carrying charges per unit under various proposed housing programs. Matters of federal taxation on housing, such as proposals for special tax benefits for rental housing, are also analyzed in this Branch.

The Division of Slum Clearance and Urban Redevelopment, in the Office of the Administrator, includes a Municipal Finance Branch which studies city finance problems

in connection with specific project proposals. This Branch has made a start toward a comprehensive study of long-term trends in city financing, with the objective of anticipating revenue problems that will need to be faced in the years ahead.

The Community Facilities Service, Division of Community Facilities and Special Operations, in the Office of the Administrator, has to make determinations in specific cases whether or not local tax revenues would be sufficient to bear the cost of facility installations necessitated by a defense housing program in a locality. Based on a financial analysis in each case, a determination is made, in accordance with Public Law 139 (September 1, 1951), whether a local community may receive a grant, a loan, or a combination thereof from the federal government in order to finance the necessary community facility, such as a water supply line or a sewage disposal system.

The Management and Disposition Division, Public Housing Administration, includes a Taxation Branch which is responsible for determining the amount of payments in lieu of taxes to be made to local jurisdictions. Determinations of this character are made for low-rent public housing projects, Lanham Act housing, and projects provided under the Defense Housing and Community Facilities and Services Act of 1951. The statutory requirements for making these payments are different in each case. The Branch ascertains local tax laws and assessment standards and procedures, determines a value for tax purposes, estimates the value of governmental services not provided by the local authorities, and computes the payments in accordance with the statutory provisions. The Branch has seven professional employees.

VIII. INTERGOVERNMENTAL TAX IMMUNITY

A. *Department of Defense* [11]

Since federal, state, and local taxes are often a significant factor affecting a contract price, various offices in the Department of Defense handle problems involving the application of these taxes to military procurement. This work is coordinated through the Tax Subcommittee of the Munitions Board's Armed Services Procurement Regulations Committee. The members of the Subcommittee are the chiefs of the tax branches in the Office of the Judge Advocate General of the Army, Navy, and Air Forces, respectively. The three tax branches have direct responsibility for formulating administrative procedure pertaining to tax exemptions and assisting procurement personnel with tax problems.

State and local tax manuals are compiled and kept up to date for the guidance of procurement officers. These manuals list by individual states all taxes which might affect procurement and clarify the liability of the United States and of contractors with the United States. The manuals are based upon state-by-state analyses of the application of all types of fuel taxes, motor vehicle excise and registration taxes, sales and use taxes, and corporate and business franchise taxes. Taxes on real and personal property and unemployment compensation taxes are subject to the same general considerations in each state and, therefore, are not treated on a state-by-state basis.

The tax branch for each of the services also handles such matters as exemptions from federal excises, problems arising under the Buck Act, and application of foreign taxes to military establishments abroad.

Questions involving the tax status of privately constructed housing on federal military installations (so-called Wherry Housing Act projects) are under the general jurisdiction of the Armed Forces Housing Agency in the Office of the Secretary of Defense. Each of the services has representatives who conduct the negotiations with local taxing authorities.

B. *Atomic Energy Commission*

Problems regarding the application of federal, state, and local taxes to contractors and suppliers for Atomic Energy Commission projects are analyzed in the Division

[11] Also, see X below.

of Finance. The legal issues raised in this connection are handled by the General Counsel's Office. These problems have recently become more numerous and more difficult to resolve because of new court decisions.

IX. FOREIGN TAX SYSTEMS [12]

Mutual Security Agency, Office of Statistical Coordination

Foreign tax studies are prepared in the Progress Branch, Division of Statistics and Reports. In addition to compiling international comparisons of tax levels and public debt, the Branch reports on fiscal developments abroad which are of international interest. Annual revenue and expenditure statistics are assembled for a large number of countries and classified on a uniform basis. Differences among the countries are highlighted through the use of ratios to gross national product and other measures.

The Branch works closely with the Fiscal Division of the United Nations. In most instances the required information is not available from existing sources and can be obtained only from special questionnaires which are submitted to Mutual Security Agency missions abroad for completion.

[12] Information on foreign tax systems often is available from the Department of Commerce, Office of International Trade, and the Board of Governors of the Federal Reserve System, Division of International Finance.

X. MISCELLANEOUS

Department of Defense [13]

The Armed Services Individual Income Tax Council comprises three members, one representative from each of the services. The Council operates under a Liaison Officer, at present the Navy member on the Council, who represents the services in negotiations with the Treasury and Bureau of Internal Revenue. An important responsibility of the Council is to assist with the preparation of official regulations and Treasury Department rulings relating to special income tax provisions for military personnel. The Council also assumes over-all responsibility in the Department of Defense for the dissemination of information regarding the federal income tax to military personnel and civilian employees of the Department.

Under the direction of the Navy member, who is in the Bureau of Supplies and Accounts, a pamphlet is prepared and published after each major revenue act, which describes in detail for service personnel their income tax rights, benefits, and obligations. The Navy member also is in direct charge of the indoctrination of personnel who assist both servicemen and civilians in the Department with the filing of their income tax returns.

[13] Also, see VIII-A above.

Nominations for Officers

The proper choice of officers and directors of the Association is the business of all the members. The Nominating Committee elected at the Toronto Conference will soon meet to consider the nomination of officers and members of the Executive Committee of the Association. **The Committee earnestly desires suggestions from members of the Association of persons considered best qualified to carry on the work of the Association.**

The most difficult task of the Committee will be the choice of a nominee for Vice President who, if elected to that office, would be expected to succeed to the presidency. Many persons, including the Chairman of your Committee, feel it is wise for the Association to follow a plan of rotation in choosing a nominee, choosing in one year a representative from state administrators, in the second year a representative from the field of business, and in the third year a representative from the teaching profession. If this principle is followed by the present Nominating Committee, they will choose for Vice President a representative of the teaching profession. **It seems especially desirable, therefore, that you should advise the Committee as to members of the teaching profession whom you consider qualified for the presidency.**

The Committee desires your help also in choosing three members of the Executive Committee to fill the vacancies which will be caused by the expiration of the terms of Robert S. Ford, Mortimer M. Kassell, and Spencer E. Bates.

Please address your suggestions to William A. Sutherland, Esquire, 602 Ring Building, Washington 6, D. C.

Lawton B. Chandler
J. L. Reuther
C. Emory Glander
Carl S. Shoup
William A. Sutherland,
Chairman

NATIONAL TAX ASSOCIATION

Organized 1907 — Incorporated 1930

OBJECT. The National Tax Association is a non-political, non-sectarian, and non-profit-making educational organization. Its object, as stated in its certificate of incorporation, is to educate and benefit its members and others by promoting the scientific study of taxation and public finance; by encouraging research; by collecting, preserving, and diffusing scientific information; by organizing conferences; by appointing committees for the investigation of special problems; by formulating and announcing, through the deliberately expressed opinion of its conferences, the best informed thought and ripest administrative experience available; and by promoting better understanding of the common interests of national, state, and local governments in the United States and elsewhere, in matters of taxation and public finance and interstate and international comity in taxation.

MEMBERSHIPS. The Association welcomes to its membership, for mutual discussion and deliberation, all who may be interested in taxation and public finance generally. Annual dues are: junior memberships for individuals under thirty-five years of age, $5; senior memberships for government agencies and educational institutions and their personnel, $10; senior memberships for other individuals and organizations, $15; sustaining memberships, $100 to $1,000.

PUBLICATIONS. The NATIONAL TAX JOURNAL is published quarterly in March, June, September, and December. PROCEEDINGS of the annual conferences on taxation which are sponsored by the Association are published soon after the meetings. The JOURNAL and the PROCEEDINGS are sent to members without charge. To non-members the price of the JOURNAL is $5.00 per year, single numbers, $1.50. The prices of the PROCEEDINGS vary; that of the 1952 volume is $6.75.

Applications for membership, orders for publications, and general inquiries should be addressed to Ronald B. Welch, Secretary, National Tax Association, P.O. Box 1799, Sacramento 8, California.
